November 2016
Perspective
Global Equity

ESG Investing and Portfolio Integration

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Interest in environmental, social, and governance (ESG) factors is expanding at a rapid pace among institutional and retail investors around the world. In this paper, we provide an overview of the sustainable investment landscape, including investor adoption and implementation trends, as well as important sustainable investment themes from an industry perspective. We also explore the opportunities and challenges of integrating nonfinancial factors within traditional fundamental company analysis.

Interest in ESG factors is expanding at a rapid pace among institutional and retail investors around the world. Growth in sustainable investing initiatives by asset owners is driving increased demand for ESG ratings on companies and portfolios, as well as ESG-themed investment products and benchmarks. From a pension fiduciary perspective, updated guidance from the U.S. Department of Labor—clarifying that ESG factors are consistent with fiduciary duty—has further solidified the momentum behind sustainable investing.

The evolution of sustainable investing has been influenced by not only the changing objectives of asset owners, but the inherently dynamic nature of ESG factors themselves. Governance factors remain highly relevant, as evidenced by some of the more recent corporate scandals including Volkswagen and Toshiba. Traditional socially responsible considerations continue to be important to many asset owners, but social factors within the broader ESG framework extend beyond the "no sin" domain. At the same time, environmental considerations are gaining prominence among asset owners, who increasingly recognize the material impact that these factors can have on portfolio risk and returns. The historic Paris Agreement on climate change, recently ratified by China, India, and the United States, is already shaping public policy and corporate action.

ESG implementation strategies vary widely across asset owner types, depending on unique objectives and beliefs. Although fairly entrenched in Europe, Canada, and Australia, the concept of ESG is less understood among U.S. investors—many of whom still equate it strictly to values-based social screening. A significant portion of the investor base remains skeptical of the merits of ESG factors from a performance perspective, despite mounting academic evidence to the contrary. In this article, we provide an overview of the sustainable investment landscape, including investor adoption and implementation trends, as well as important sustainable investment themes from an industry perspective. We also explore the opportunities and challenges of integrating nonfinancial factors within traditional fundamental company analysis.

Trends and Terminology (Alphabet Soup)

Sustainable investing means many things to many people; there is no standard definition. Acronyms such as ESG, RI (responsible investing), and SRI (socially responsible investing) are used interchangeably. The terms *social investing, ethical investing, values-based investing, mission-based investing, and socially conscious/aware investing* have been commonly used to describe the integration of religious or moral beliefs in portfolio management, typically implemented through negative screening. Generally defined as SRI, this form of integration became more popular among U.S. investors in the 1960s and 1970s. This trend was also evident in Europe, where rising environmental consciousness amid disasters such as the Exxon-Valdez oil spill further solidified the responsible investment movement and expanded its breadth.

In contrast to environmental and social factors, governance considerations have been more widely integrated into investment decisions for decades. Information about accounting, corporate boards, pay practices, and ownership has been more commonly available than environmental and social-related disclosures. The risks of poor governance are also fairly well understood among investors, and have been reinforced by the seemingly routine frequency of high-profile corporate scandals. Toshiba's accounting shenanigans and Volkswagen's monumental deception of environmental regulators and governments are just the latest examples of corporate malfeasance destroying shareholder value.

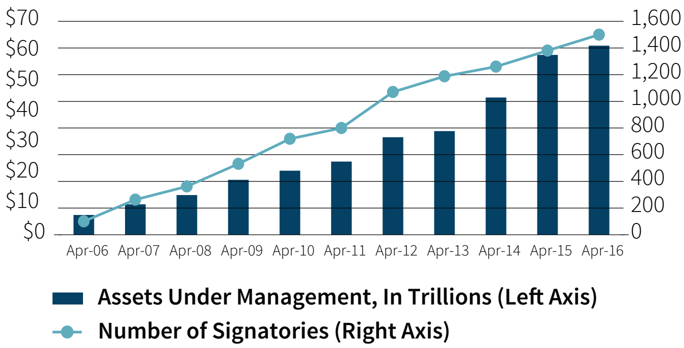
The positive link between governance and shareholder returns has been routinely confirmed in academic studies. In their influential paper, "Corporate Governance and Equity Prices," economists Paul Gompers, Joy Ishii, and Andrew Metrick examined the relationship between shareholder rights, stock returns, and corporate performance over time. "Our results demonstrate that firms with weaker shareholder rights earned significantly lower returns, were valued lower, had poorer operating performance, and engaged in greater capital expenditure and takeover activity," wrote the authors.[1]

1 Paul Gompers, Joy Ishii, and Andrew Metrick, "Corporate Governance and Equity Prices," *The Quarterly Journal of Economics,* MIT Press, vol. 118(1), pages 107-155, February 2003.

Does it Matter?

Research into the efficacy of ESG/sustainability factors has expanded in recent years amid the growing popularity of responsible investment initiatives, most notably the United Nations–supported Principles for Responsible Investment (PRI), whose signatories accounted for more than $60 trillion in assets under management as of April 2016. Figure 1 illustrates.

Figure 1:
PRI Signatories and AUM



Source: PRI, as of April 2016.

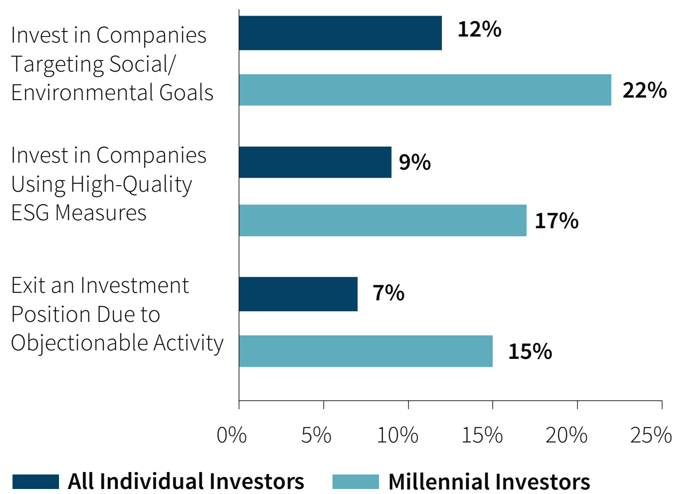
This tremendous growth has naturally fueled further debate about the merits of sustainable investment from a financial return perspective. In 2007, consulting firm Mercer published its original analysis of 20 multiple academic studies that examined the link between ESG factors and financial performance, which helped address concerns about sustainability objectives limiting return opportunities. Mercer's report was updated in 2009 to include 16 additional studies, and the results were compelling: 20 of 36 studies indicated a positive relationship between ESG factors and financial performance, while only 3 studies showed evidence of a negative relationship.[2] With respect to the component E, S, and G factors, Mercer noted that strong corporate governance and social considerations such as racial diversity and employee satisfaction can lead to improved performance. The performance impact for environmental factors was mixed among the academic studies that Mercer reviewed, primarily because of the wide variation in materiality across industries.

InterSec Research has approached the debate from a different angle, comparing returns of PRI signatories and non-signatories across different equity manager universes. As measured by quarterly rolling three-year periods, InterSec found that PRI signatories outperformed non-signatories in both the global core (MSCI World Index) and all country world (MSCI ACWI) equity universes consistently over time.[3]

More recent research into performance effects has tried to differentiate between material and nonmaterial ESG issues across different industries. The recognition of materiality is a positive development, with studies seeking to address the different risks facing energy and healthcare companies, for example. Using materiality guidance from the Sustainability Accounting Standards Board (SASB), George Serafeim and his colleagues at the Harvard Business School found that firms with better performance on material ESG issues experienced a 9% greater margin improvement on a five-year basis. Controlling for systematic risk, they also analyzed stock prices for each decile of "ESG improvers" on material industry factors, which demonstrated significant outperformance of the top 10% of companies versus the bottom 10%.[4]

While further research is being conducted into the benefits of sustainable investing, demographic trends are propelling ESG into the forefront of investor awareness regardless of the quantitative evidence. Millennials tend to focus more on sustainability than previous generations, viewing themselves as global citizens who have a responsibility to make the world better. All else equal, they will choose a brand or decide where to shop based on a company's commitment to environmental and social issues. There is also evidence that they will pay a premium for brands associated with sustainability. According to the Morgan Stanley Institute for Sustainable Investing, millennials are twice as likely to purchase a brand because of the company's environmental and/or social impact. They are also nearly twice as likely to invest in companies or funds that target specific sustainable outcomes, as shown in figure 2.

Figure 2:
Millennial Investor Sustainability Considerations



Source: Morgan Stanley, as of July 2016.

These preferences have certainly not been lost on investment managers, brokerage firms, and service providers, who have responded with a plethora of ESG-themed research and products in recent years. Among the more interesting and potentially influential developments are the ESG fund ratings systems introduced by Morningstar and MSCI in 2016, which allow investors to compare funds across different sustainability metrics based on underlying holdings.

2 "Shedding Light on Responsible Investment: Approaches, Returns and Impacts," Mercer, November 2009.
3 2015 Mid Year Investment Industry Research Report of the U.S. Tax-Exempt Cross-Border Marketplace, InterSec Research.
4 Khan, Mozaffar and Serafeim, George and Yoon, Aaron S., "Corporate Sustainability: First Evidence on Materiality" (March 9, 2015). *The Accounting Review*, forthcoming. Available at SSRN: https://ssrn.com/abstract=2575912

Sustainable Growth Themes

Governance factors remain highly relevant from a risk and return perspective, but the delta for growth in ESG factor integration (or sustainable investment adoption) will continue to be more a function of the environmental and social trends that are reshaping industries and business models. Changing consumer preferences, disruptive technologies, and the shifting regulatory environment have presented companies with a mix of risk and return opportunities across a number of industries.

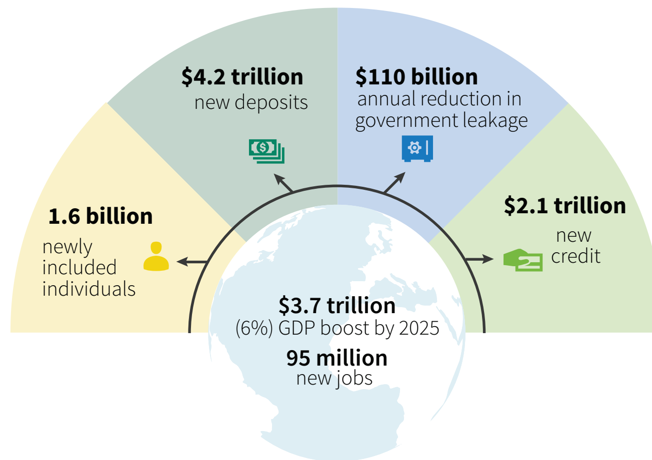
Based on its analysis of global sector exposures to sustainability issues, UBS highlighted the energy and transportation-related sectors as being most exposed to ESG risks. These risks are primarily related to CO2 regulations, new forms of mobility, and innovative technologies. Certainly many companies in these industries are adapting to these risks to neutralize the effects on revenues, but profitability and return on capital are under threat. At the other end of the spectrum, consumer-related industries are considered to be more favorably exposed to ESG issues, as sustainability trends such as organic products and health awareness are net positives.[5]

While risk mitigation remains a key objective of sustainable investing, longer-term thematic-oriented return opportunities are emerging across a wide range of industries. These themes are broadly tied to shifting demographics, climate change, resource scarcity, and improvements in quality of life—particularly in developing economies.

The financials, technology, and telecom sectors are not traditional areas of focus for investors pursuing ESG objectives, but the growth of digital finance (where these sectors intersect) is proving to be a compelling sustainable investment theme. The proliferation of mobile devices and rising demand for banking services among lower-income populations have facilitated the creation of innovative payment platforms with high levels of adoption among the "underbanked" demographic. This is particularly important in emerging markets, where most people and small businesses transact exclusively in cash and do not participate in the formal financial system.

According to a recent study by the McKinsey Global Institute, nearly 80% of adults in emerging markets own a mobile phone, but only 55% have a financial account. McKinsey estimates that 1.6 billion people out of 2 billion without bank accounts—more than half of whom are women—could be assimilated into the system via digital finance.[6]

Figure 3:
Digital Finance Impact in Emerging Markets



Source: McKinsey Global Institute, as of September 2016.

The ability to accept wages, subsidy payments, and remittances or initiate tuition, medical, and rent payments from the palm of the hand is both convenient and empowering. From a macroeconomic perspective, rising loan demand and deposit growth are favorable outcomes of the migration to digital. Economic gains can potentially be achieved through productivity gains and lower costs from reducing cash transactions and brick-and-mortar branches. Among developing economies, McKinsey sees the most potential for low-income countries in Africa and in India, where digital finance could increase gross domestic product (GDP) growth by 10% to 12%. Although less significant, the estimated 4% to 5% estimated growth benefits for middle-income countries such as China and Brazil are also compelling.

5 Global ESG Analyser. UBS, April 2015.
6 McKinsey Global Institute, "How Digital Finance Could Boost Growth in Emerging Economies," September 2016.

ESG Implementation Approaches

In an effort to more formally quantify ESG investment trends, the Global Sustainable Investment Alliance (GSIA), a collaboration of membership-based sustainable investment organizations, began aggregating the results of regional market studies for Europe, Australasia, Africa, and North America in 2013. For the purposes of gathering data for its annual *Global Sustainable Investment Review*, GSIA used a broad definition of sustainable investing, inclusive of the following activities:[7]

- ***Negative/exclusionary screening:*** the exclusion of certain sectors or companies based on specific ESG criteria;
- ***Positive/best-in-class screening:*** investment in sectors or companies selected for positive ESG performance relative to peers;
- ***Norms-based screening:*** screening of investments against minimum standards of business practice based on international norms;
- ***Integration of ESG factors:*** the systematic inclusion of ESG factors into traditional financial analysis;
- ***Sustainability-themed investing:*** investment in themes or assets specifically related to sustainability;
- ***Impact/community investing:*** targeted investments aimed at solving social or environmental problems, and community investing; and
- ***Corporate engagement and shareholder action:*** the use of shareholder power to influence corporate behavior, including through direct engagement with management and/or boards, filing shareholder proposals, and proxy voting that is guided by ESG guidelines.

Recognizing that these approaches are not mutually exclusive, the GSIA adjusted for double counting in the aggregation of data for reporting purposes.

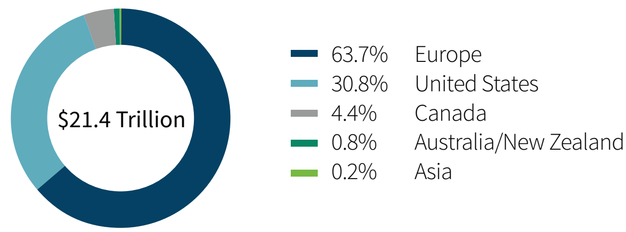
Combining the assets under management in all of these approaches across different geographies, the GSIA data showed that global sustainable investment assets nearly doubled from $13.3 trillion in 2012 to $21.4 trillion in 2014. As illustrated in figure 4, Europe accounted for the largest share of total assets by a wide margin.

A more informative perspective on geographic representation is the size of sustainable investment assets relative to total professionally managed assets in each region, as shown in figure 5.

This more clearly illustrates the relative importance of sustainable investing in Canada and Australia, and highlights its strongly growing presence in the United States.

Perhaps not surprisingly, the majority of global sustainable investing assets used negative/exclusionary screening as the primary means of implementation. From a geographic

Figure 4:
Assets by Region



Source: GSIA as of 2014.

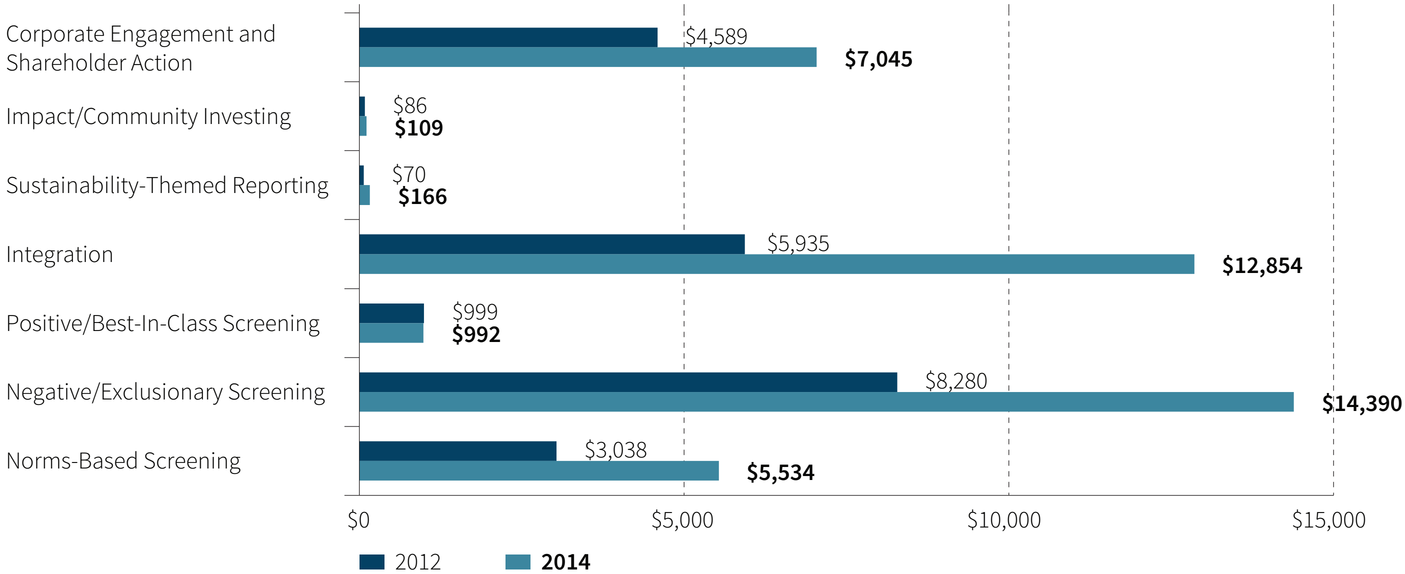
Figure 5:
Proportion of Sustainable Assets vs. Total Managed Assets

	2012	2014
Europe	49.0%	58.8%*
Canada	20.2%	31.3%
United States	11.2%	17.9%
Australia	12.5%	16.6%
Asia	0.6%	0.8%
Global	21.5%	30.2%

Source: GSIA as of 2014. *This figure is based on the aggregation of all SRI strategies reported in the European SRI Study 2014 without double counting, and is presented in order to be consistent with the methodology of this global report. Please note, however, that this figure is not used in the European study as there is no single European definition for sustainable investing.

7 GSIA, 2014 *Global Sustainable Investment Review.*

Figure 6:
Growth of ESG Strategies (in Billions), 2012-2014



Source: GSIA as of 2014.

perspective, the GSIA data showed that European and Canadian assets were more diversified across different implementation strategies: in addition to negative screening, there were a higher proportion of assets using norms-based screening, corporate engagement, and integration approaches. Within the United States, the primary forms of implementation were integration, negative screening, and corporate engagement.

From a global perspective, figure 6 shows that negative screening dominated, but integration strategies grew at the fastest rate (47% annual growth rate for the two-year measurement period).

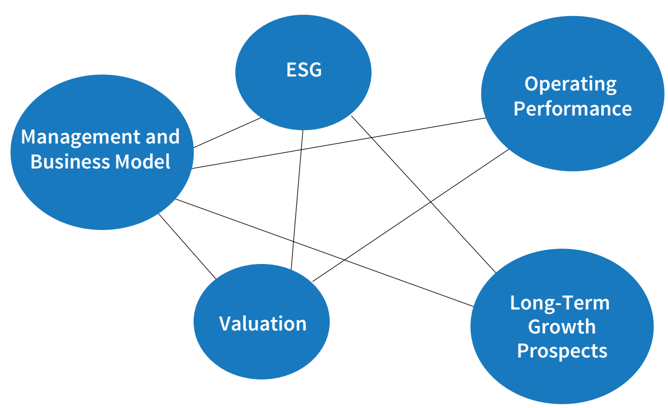
Emergence of ESG Integration

It is important to bear in mind that integration is itself a broadly defined category, with varying degrees of systematic processes used across different industry participants. For example, the pan-European stakeholder network Eurosif has noted the growing prevalence of less structured integration among European asset managers, whereby separate analysts are employed to focus exclusively on ESG factors and share their views with mainstream portfolio management teams.[8] Addressing ESG factors through this type of fragmented team structure may be useful in more explicitly demonstrating a manager's ESG focus to clients and prospects, but its effectiveness from a holistic company analysis perspective is debatable. The isolation of the ESG function that is implicit in separate team structures may, ironically, make it more difficult to achieve seamless integration.

Integrating sustainability and governance considerations into traditional analysis is becoming more appealing as investors realize that many elements of ESG are inextricably linked with company quality. The increasing prevalence of sustainable growth investment themes, and their impact on future earnings prospects for companies across a range of industries, has contributed to a more implicit incorporation of ESG into investment decisions. An automotive components research analyst, for example, needs to understand the implications of vehicle safety, efficiency, and automation trends for future order book growth and profit margins. As highlighted in the previous mobile payments example, these themes are naturally facilitating more cross-sector collaboration among asset management teams. Similarly, with respect to autos, the emergence of innovative vehicle technologies such as advanced driver assistance systems (ADAS) is altering the return profile and competitive dynamics for the semiconductor industry.

Achieving ESG portfolio integration in a systematic way has been complicated by a lack of corporate disclosure and poor data quality. The wide variation in sustainability reporting and

Figure 7:
ESG in Fundamental Analysis: Integrated Decision Framework



8 Eurosif, "The State of SRI in Europe—Past, Present, and Future," *GreenMoney Journal*, July 2015.

disclosure practices across geographies and market capitalizations (i.e., companies based in emerging markets tend to report less than developed market counterparts, while small and midsize enterprises have fewer resources to produce glossy corporate social responsibility reports). This has historically translated into weaker global universe coverage by ESG ratings providers and traditional research firms. The tide is turning, however, as more companies are being required by asset owners and regulators to report on ESG factors.

Reporting standardization initiatives are working to help overcome portfolio integration obstacles. SASB, the Global Reporting Initiative (GRI), the International Integrated Reporting Council (IIRC), the Carbon Disclosure Project, and others are seeking to advance corporate disclosure on sustainability issues. The challenge is related more to the quality of reporting rather than the quantity: According to the GRI, from 2005 to 2015 the number of companies issuing sustainability reports increased nearly 13 times, from 436 to 5,634.

Governments and stock exchanges are also playing a bigger role in mandating reporting and seeking to improve reporting quality. According to the nonprofit organization Ceres, there are approximately 180 laws and regulatory standards in 45 countries requiring some form of corporate sustainability reporting. From a stock-exchange perspective, investment banking firm CLSA notes that five major Asian exchanges will introduce reporting requirements in the next three years. See figure 8.

Importantly, there is a concerted effort between SASB, GRI, IIRC, and exchanges to streamline reporting and emphasize metrics that are most relevant to investors (i.e., those that have potential financial impact). We expect data quality to improve with these reporting initiatives, helping win over ESG skeptics and encourage broader integration adoption.

Summary

ESG investing means many things to many people. Whether investment objectives are corporate-governance-focused, community-impact-driven, socially aware, or environmentally motivated, one thing is clear: asset owners and investment managers will find it increasingly difficult to ignore these issues in the coming years. Hurdles to effective portfolio integration remain but are being addressed on multiple fronts. As material ESG factors are more consistently disclosed and measured, their contribution to corporate performance is likely to become more evident, encouraging broader adoption of portfolio integration strategies across the asset management industry. ■

Figure 8:
Asia Stock Exchange Sustainability Reporting

	2012-2014	2015	2016	2017	2018
Japan	2014: Japan's stewardship code established (V)	Japan's corporate governance code established (M)			
Malaysia				Listed companies with market caps greater than RM 2 billion to issue sustainability report by fiscal year 2016 annual reports (M)	
China			2016: Mandatory environmental disclosure for all listed companies (recommended)		
Taiwan		CSR reporting for select companies begins (M)			Companies listed on the Taiwan Stock Exchange with capital greater than NT 10 billion must issue CSR reports by fiscal year 2017 annual reports (M)
South Korea			2016: Corporate governance Guideline by KSE and FSC (planned) Stewardship code (planned)		
Singapore				By 2018, primary-listed companies must report (M) four core requirements, including board responsibility and relevant reporting framework (CE)	
Hong Kong	2012: ESG guide implemented (CE)			From 2017, listed companies must report environmental KPIs (CE)	

Source: Bloomberg, exchanges, CLSA, as of September 2016. M = mandatory, V = voluntary, CE = comply or explain.

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