Is Environmental, Social and Corporate Governance (ESG) Investing Right for You?

First National Bank

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For many people, investing is about more than preparing for the future or growing wealth. It's a way to support companies with good business practices and make a positive impact in the world. Socially responsible investing has witnessed significant growth in recent years. Seventy-five percent of individual investors are now evaluating environmental, social and governance—or ESG—criteria when making investment decisions, a number that rises to 86 percent among millennials.[i]

Taking an ESG or sustainable approach gives investors the chance to influence issues of personal importance, but a growing body of evidence also suggests that companies focused on ESG criteria may perform better, providing an opportunity for higher returns.

If you're wondering if ESG investing is right for you, it's good to start with a sound understanding of ESG investment strategies.

Understanding the ESG Investment Strategy

While exclusionary investment approaches gained popularity in the 1960s as investors eliminated certain assets from portfolios, the exclusionary approach to investing dates back to the 1900s and possibly even further. These approaches have evolved and the modern-day strategy started to take form in 2004, when former UN Secretary General Kofi Annan wrote to over 50 CEOs asking them to incorporate environmental, social, and governance standards into capital markets. Soon after, a 20-person group of investors from 12 countries was formed to create standards for responsible investing.

The resulting six criteria, known as the Principles for Responsible Investment (PRI), were launched at the New York Stock Exchange in 2006.

Principles for Responsible Investment (PRI)

The PRI were adopted by the New York Stock Exchange as the Sustainable Stock Exchanges Initiative (SSE) and exist to promote responsible investing and to guide businesses toward better environmental, social and governance responsibility:

Principle 1	We will incorporate ESG issues into investment analysis and decision-making processes.
Principle 2	We will be active owners and incorporate ESG issues into our ownership policies and practices.
Principle 3	We will seek appropriate disclosure on ESG issues by the entities in which we invest.
Principle 4	We will promote acceptance and implementation of the Principles within the investment industry.
Principle 5	We will work together to enhance our effectiveness in implementing the Principles.
Principle 6	We will each report on our activities and progress towards implementing the Principles.

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According to investment research firm MSCI, 1,800 asset owners, investment managers and service providers, representing over $68 trillion in assets under management, have voluntarily agreed to support the six primary objectives.[ii] Many companies have followed suit by aligning their core business models to meet ESG criteria. Investor interest has escalated as well, increasing 33 percent over a two-year period, according to The Morgan Stanley Institute for Sustainable Investing.[iii]

To understand why investors are embracing ESG investing, you have to first understand what constitutes an ESG investment. According to Rick Frevert, portfolio manager, First National Bank, when a business is aligned to ESG principles, they typically demonstrate a higher level of transparency.

"ESG investors are looking for companies that have open and transparent policies, are conscientious about the impacts they are having on their communities, and create healthy work environments for their employees. These companies are more likely to be perceived as ESG-friendly and receive higher ESG rankings by investors." said Frevert.

This transparency regarding a company's ESG-related practices is important as it allows investors to align their portfolio for the best returns while supporting important issues.

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Understanding Environmental Criteria

Investors are increasingly focused on environmental factors when making investment decisions.[iv] Carbon emissions, resource depletion, and alternative energy are a few of the issues addressed through environmental criteria.

Regulations or guidelines like the 2015 Paris Agreement have an impact on many companies' environmental strategies. Under the act, signing countries agreed to try to limit global temperature increases to two degrees Celsius.

Since then, companies with strong environmental standards have taken steps to meet the standards of the Paris Agreement. For example, Adobe, Gap Inc., Levi Strauss & Co., L'Oreal USA, Mars, Inc. and VF Corporation have all set science-based targets for reducing their emissions. Apple has also announced its intent to support environmental standards by powering its global facilities with renewable energy.

Organizations like these are favorably received by a growing number of investors. For instance, how companies manage their environmental impact receives a ranking of 6.5 out of 10 in importance on Schroders Global Investor Study.[v] Where millennials are concerned, meeting environmental criteria is even more important, as 75 percent believe that they can positively impact environmental factors through sustainable investing.[vi]

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Taking a Closer Look at Social Criteria

The social category of ESG investing covers a broad set of criteria ranging from employee diversity and working conditions to external factors, such as product safety, human rights, and community impact.

In recent years, human rights have become a public focal point as high-profile events, including unacceptable labor conditions, have made headlines. In response, the United Nations released the UN Guiding Principles on Business and Human Rights in 2011. Based on a "protect, respect and remedy" framework, these 31 principals were designed to set a global standard for preventing human rights violations linked to business activity and addressing those violations that do occur. Many companies have responded by implementing the principles into their business models.

Nike, for example, has evolved a dedication for advancing human rights. Early allegations regarding violations in several of the company's foreign manufacturing facilities raised calls from activists for the sports apparel giant to produce a list of all global locations. Nike responded in 2005 with a 108-page report detailing the whereabouts and conditions of more than 700 global sites where goods were produced.[vii]

The report indicated wide-spread human rights violations, particularly in Asia, where 25 percent to 50 percent of factories were operating under sub-par conditions. Since then, Nike has made a concerted effort to champion foreign workers.

In 2018, after discovering the squalid living conditions of more than 1,200 employees at the Hytex factory in Malaysia, the company moved the impacted employees into Nike-approved housing, according to Reuters. They also returned passports to several foreign workers that were being held by the Hytex manufacturer.

The social criteria of an ESG strategy primarily focuses on the company's commitment to safety and establishing a quality work environment where employees can have fulfilling careers, under fair work conditions with equal pay.

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Breaking Down Governance Criteria

Governance criteria pertain to issues of corporate behavior, including executive pay, board structure and diversity, and accounting transparency, bribery and corruption, and political lobbying. Companies with high governance standards also exhibit a regard for safe operational practices, such as taking strong cyber security measures to protect sensitive data. Corporations that fail to meet ethical standards or ideals regarding appropriate behavior often lose public favor or realize declining profits.

It's easy to see how even a hint of impropriety can negatively impact a company by reviewing Uber's state of affairs in 2017. Following accusations of sexual harassment and theft of intellectual property, Uber watched consumer sentiment turn negative and lead to a U.S. Justice Department investigation.

Allegations contend that Uber used its Greyball software to identify regulators seeking its service and deny them rides. In the wake of Greyball and other governance-related allegations, Uber's market share fell from 90 percent in 2016 to 77 percent in May of 2017, according to Sustainalytics.[vii] Considering Uber's situation, it's easy to see that damage to a company's reputation, as well as their profitability, can happen at the mere mention of corruption or abuse.

According to PRI, business corruption losses represent over 5 percent of global GDP and add up to 10 percent of the cost of doing business annually.[ix] This insight into the price of corporate corruption is one reason why governance is a major tenet of ESG investing.

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Why Adopt an ESG Investment Strategy?

For many investors, the opportunity to create positive change is a reward in itself, and ESG investments have been shown to help communities and society overall.

“Investing in ESG strategies can improve communities in several ways,” said Frevert. “Especially if you look at companies in emerging markets, for example, where they have different regulations or may have communities in need of basic things like clean water or improved infrastructure. Investing in companies that are making a big impact in those areas can really benefit those communities.”

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ESG criteria are also important for identifying future-ready companies, those best prepared to withstand market and social volatility. By aligning their portfolios to relevant principles, investors may be positioning themselves for better returns, while having a chance to take a stand on issues of importance to their own personal ethics.

For instance, research conducted by MSCI in late 2017 revealed that high ESG-rated companies attain greater profitability than low ESG-rated companies.[x]

“ESG strategies may create competitive returns in two ways,” said Spieler. “First of all, from a risk management perspective, it’s downside protection, because companies may not see as many regulatory actions against them resulting in fewer fines. Secondly, a lot of times you’re investing with companies that are industry leaders, so it’s not only from a fundamental, revenue and profit standpoint, but they are leading their respective categories in terms of responsible business practices.”

An ESG focus often results in lower risks for a business. Governance principles, for example, reduce risk across the regulatory landscape by creating a more naturally compliant organization. After setting up a cross-functional ESG policy, including a comprehensive reporting and communication program, North American auto manufacturer, ABC Group, outperformed supplier averages in all seven categories on the AIAG CSR supplier scorecard, a leading indicator of corporate supply chain sustainability for their industry.[xi]

Hermes has found that strong governance practices like these are imperative to a company's success. Organizations with strong corporate oversight "outperform their poorly governed competitors by an average of over 30 basis points (bps) per month," a trend that has been in force since 2009.[xii]

Higher profitability is also influenced by cost savings.

One example of this would be a bank that treats its employees well. As a result employees are more loyal, so there is less turnover and the bank's clients may receive better service.

According to Bersin by Deloitte research, companies incur between $3,139 to $5,380 per new hire depending upon the size of the organization.[xiii] Expenses related to first-year orientation and training add up to an additional $3,000 a year on average per new hire.[xiv]

According to the Society for Human Resource Management (SHRM), companies experience a turnover rate of 19 percent on average.[xv] That means that an organization with 1,000 employees could expend over $1 million a year due to turnover.

On the other hand, companies with a highly engaged workforce realize 21 percent greater profitability.[xvi] These outcomes may pad the bottom line, potentially returning more money to shareholders.

How Can I Align My Portfolio to an ESG Investment Strategy?

A basic format for aligning portfolios to an ESG strategy would include:

- ***Integrate:*** Evaluate companies based on systematic consideration of financial and nonfinancial (ESG) factors and select the most attractive investments.
- ***Best in Class:*** Invest in companies from each industry that rank highest in relevant fundamental and ESG factors.
- ***Impact:*** Choose companies that are developing solutions to ESG concerns.
- ***Thematic funds:*** Some investors with a strong desire for change on a particular issue prefer to invest only with companies that attend to those issues, such as taking a stance on reducing carbon emissions.

When it comes to investing, there are different methods of analyzing and rating investments. Investment research firm MSCI, for instance, ranks organizations on 37 key issues that are annually selected for each industry. The firm then grades companies relative to their industry peers, providing a grade in the AAA to CCC range.

MSCI believes that companies within the same industries will generally share the same set of opportunities and risks. An opportunity or risk is considered pertinent, or material, to an industry if the majority of participants could make a profit or experience a substantial loss due to a given factor.

Sustainalytics, a leading independent provider of research and ratings, also ranks companies according to material risks, taking into account how well the entity is handling those factors. More than 40 industry-indicators are used to rate a company on a zero to 100 scale, ranking risk from negligible across three interim ratings up to severe.

Ratings serve to rank a company's performance and commitment in relation to ESG criteria and help investors identify investments that are aligned to ESG principles, but wealth management advisors and fund managers rely on a wide range of resources when evaluating a company's sustainability practices and ESG standing.

The Morningstar Sustainability report, for instance, ranks companies against others in the area of ESG criteria. While this information is useful in determining how competitive a company is in relation to its ESG policies and practices, it doesn't provide a full understanding of its investment potential. It's also important to understand the company's financial standing, policies and procedures, as well as the steps they've taken to incorporate ESG principles into operational models and strategies.

ESG investing is becoming an increasingly popular investment approach, with 80 percent of investors interested in customizing their portfolio to meet their interests and goals.[xvii] However, when following an ESG investment strategy, it's important to keep sight of the bigger picture. Eliminating companies from your portfolio on the basis of the organization's industry alignment could be short sighted. For example, failing to consider an investment because it is associated with non-renewable sources of energy could preclude investors from taking stock in many strong ESG investments.

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"People fall into the trap of wanting to exclude all companies in certain industries," said Frevert. "But it is possible to find companies within the energy sector, for example, that are working to improve efficiencies, operate cleaner or reduce negative environmental impact which can help to improve the industry as a whole."

Portland General Electric (PGE) is an example of one of these companies. PGE has supplied electric power to Oregon residents for 130 years but has recently put a series of sustainable initiatives into effect designed to meet the requirements of the Paris Agreement. In 2018, the company committed to reducing their greenhouse gas emissions by more than 80 percent by 2050 through the increased use of renewable energy, clean technology and a more efficient energy grid.[xviii]

Get Help When You Need It

Because of the breadth of information required to select a strong ESG portfolio, investors alone may not find it easy to evaluate a company on its sustainability initiatives. According to EY's survey, 32 percent of respondents found annual reports to be a very useful tool in researching investments, but 60 percent believe companies don't report ESG risks that could have an impact on their business.[xix]

This is where a wealth management advisor can help. If ESG investing appeals to you, contacting a wealth management professional is a good first step toward realigning your portfolio to strong ESG standards.

First National Bank launched its ESG Mutual Fund Strategy in early 2018 after thoroughly researching the model. The strategy is designed to generate competitive returns while investing in companies that prioritize responsible business practices.

If interested in First National Bank's ESG First Investment Strategy, contact *FirstNationalBankWealthManagement@fnni.com.*

About First National Bank Investment Management

Since 1929, our sole mission has been to help families pursue and achieve their financial goals. We manage $9.3 billion in assets with $32.5 billion under administration, allowing us to offer the expertise of a very large investment firm, but with the service and personalized attention of a boutique firm.

We use a team decision-making approach for investment strategies and employ 38 experienced investment professionals, 19 of whom hold the Chartered Financial Analyst® designation.

We want you to feel confident in our work as a fiduciary on your behalf. That's why we offer fee-based services, rather than commission-based. This ensures that our goals and objectives are aligned with yours. As your assets grow, we grow as well.

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