Morningstar Investment Management Insights
What is Sustainable Investing?

April 2019

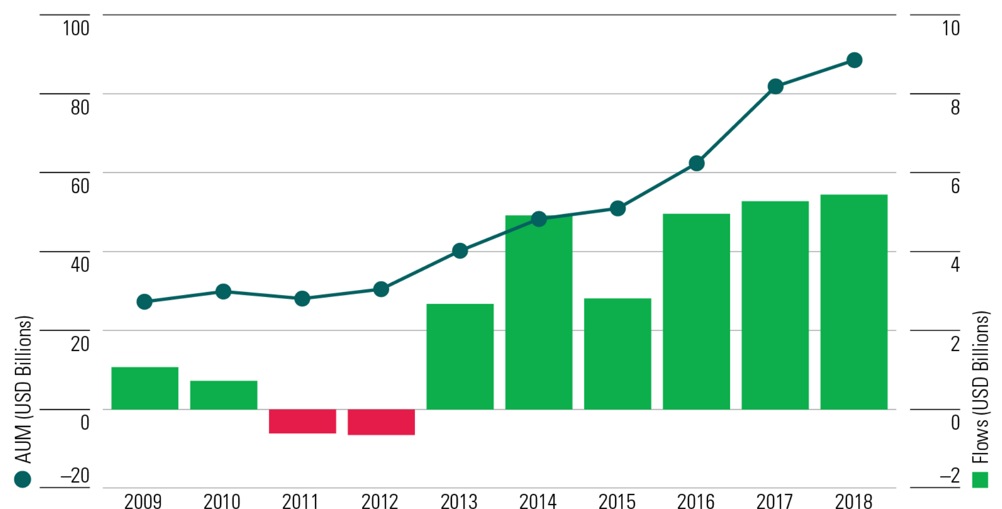
Estimated Reading Time: 5 Minutes

For Financial Advisers and Their Clients Using Our Portfolios

A Moral Movement: What You Need to Know in 5 Minutes

ESG or sustainable investment strategies have attracted considerable interest from investors recently, with total assets under management growing at an extraordinary rate (see Exhibit 1). We discussed this movement with the investment professionals at Morningstar Investment Management, to learn more about investing in a way that incorporates environmental, social, and governance elements.

Exhibit 1 Sustainable Investing: A Decade of Growth



Source: Morningstar Direct™. Data as of 31 March 2019.

What is sustainable investing?

Sustainable investing marries the traditional economic approach (aiming for the best risk-adjusted returns) with a desire to improve corporate practices and benefit society and the environment. It's come in many forms and by many names over the years, but today the focus is squarely on investment return while still striving to do good.

"ESG" is the hallmark acronym, which refers to environmental, social, and governance factors that investors use to evaluate a company. Performing well in these areas can benefit society, but it can also help reduce the risks a company passes on to its equity and bond investors. Environmental factors might include how well a company reduces the pollution it creates, the water it uses, or the carbon it emits. Social factors may include supply chain management, wage standards, or diversity policies. And governance includes corporate board structure, executive pay, prevention of bribery and corruption.

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Exhibit 2 Sustainable Investing Considers Environmental, Social, and Governance Factors

Environmental	Social	Governance
Carbon emissions Energy efficiency Water scarcity Waste management Pollution mitigation	Diversity and workplace policies Labor standards Supply chain management Product safety and usefulness Customer privacy Community impact	Board structure Board composition Executive compensation Political contributions & lobbying Bribery and corruption policies & oversight Strategic sustainability oversight

Source: Morningstar Research Services.

Risks to investors are easy to recall—think about BP's Deepwater Horizon oil spill in the Gulf of Mexico in 2010, Nike's sweatshop scandal in the 1990s, or, more recently, Facebook's data privacy scandal. ESG investors seek to avoid these risks by divesting from or engaging with companies with poor practices.

What are some of the benefits of sustainable investing for an investor?
Many investors care about ESG issues and want to invest in a way that reflects their views. Sustainable investing seeks benefits for society, supporting things like environmental responsibility, employment equality and transparency regarding corporate affairs. But it aims to accomplish these benefits while delivering returns similar to those of traditional strategies. Bad corporate behaviour on ESG issues can hurt shareholder value, but sustainable investing seeks to reduce ESG risks and deliver strong performance.

What are some benefits of sustainable investing?
We believe it can be a differentiator—you may reach different clients than you otherwise would have without considering sustainable portfolios. Given the huge influx of investor cash into sustainable investments, it seems like a warranted addition to an investors' opportunity set.

Also, it may help behaviourally, incentivising an investor to remain invested through good times and bad—ultimately helping to achieve financial goals. That is, sustainable investing holds a dual goal of doing good and investing well, so an investor may be more dedicated to their portfolio and stand by their investments so as to not affect funding projects or companies they believe in.

How does someone invest sustainably? What are some pitfalls?
Sustainable investing requires an additional layer of data and analysis than traditional strategies use. ESG analysts evaluate a company on a range of factors, typically rolling up those scores into simple metrics that investors may use when making investment decisions.

This data is available mostly for public companies, although the quality of data is better in developed markets than emerging ones. The limited availability of good ESG data has been somewhat of a stumble for ESG investors in the past, but things have improved greatly.

Today, practically all major asset classes are available to ESG investors via mandated funds. Also, investment managers have grown significant in-house expertise, adding ESG-focused analysts and specialists to do for proprietary research (in addition to ESG data from providers like MSCI or Sustainalytics), and help with board/executive engagement and proxy voting.

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Why are Morningstar launching ESG managed portfolios in the U.K. and U.S.? And why might an investor choose to invest in an ESG managed portfolio?

The managed portfolio structure allows for a number of benefits for ESG investors. First, it can provide diversified investment exposure to ESG-friendly assets. That means not just investing in a U.K. or U.S. equity fund but having broad diversification within equities and bonds. This allows an investor to make the entire portfolio ESG-friendly while being able to help improve risk and return with a larger investment universe.

Also, managed portfolio providers can do deep dives into both actively managed funds and passive or so-called smart-beta ETFs that weight companies based on ESG credentials rather than company size. There's considerable knowledge and insight among some very capable ESG portfolio managers out there, but you have to be able to find them. Doing so can bring a diversification of ESG philosophies to bear on an investment process, which we believe can be very helpful. With the Facebook example, some fund managers might exclude this company from their portfolio due to governance issues, while others might relish the chance to invest and push for changes at the firm. We believe this diversity creates a more robust ESG approach and better portfolio outcomes. M

Further information

Please contact your Financial Adviser for further information.

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