Marquette Associates

The Future of Investing: Sustainability and ESG Integration

February 2020

The Future of Investing: Sustainability and ESG Integration

Contents

03 Background
04 ESG Reporting
05 Our Approach

Linsey Schoemehl Payne, Vice President

February 2020

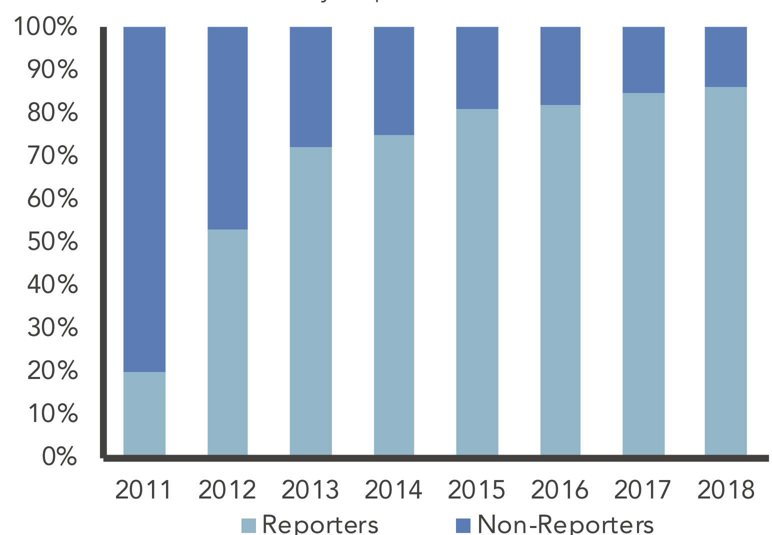
BACKGROUND

With 2020 underway, sustainable investing continues to be a trending topic, although the concept of incorporating environmental, social, and governance (ESG) metrics into an investment thesis is not new. According to a 2019 survey of 800 institutional investors representing $16 trillion of assets under management across Europe, North America, Latin America, and Asia, only 11% reported no use of ESG considerations.[1] The concept of ESG integration was first coined in a 2005 study by the United Nations (UN), which shortly thereafter launched the UN Principles for Responsible Investment. The study, written by Ivo Knoepfel, made the case that embedding ESG factors into capital markets is positive for businesses and leads to more sustainable markets and better societal outcomes. ESG integration builds on the Socially Responsible Investing (SRI) movement, which focuses on moral and ethical criteria and has historically relied on divestment or negative screening for implementation (although many investors are beginning to incorporate positive screening as well). Conversely, ESG integration is returns-focused and incorporates long-term sustainability factors into the investment research process to identify companies with higher return potential. These factors — the materiality of which are industry dependent — cover a wide spectrum and can address topics such as how corporations manage their water supply, treat their workers, and oversee their supply chains.

In August 2019, the Business Roundtable pushed the envelope on ESG integration by redefining the role and responsibility of a corporation. In its statement, signed by 185 public and private Fortune 1000 firms (including Apple, Amazon, and Exxon Mobil), the group committed to not only generating long-term value for shareholders, but also to delivering value to customers, investing in employees, dealing fairly and ethically with suppliers, and supporting communities. Large investors such as BlackRock have also come out in support of this stakeholder approach to governance. This commitment represents a break from the long-held corporate creed that the sole purpose of the corporation is to advance the interests of its shareholders and is consistent with the view taken in Europe, where companies have long recognized the relationship between business and society (and where government regulation has supported the same).

What does this mean for corporate America and ESG integration going forward? One key difference between Europe and the U.S. is the breadth of regulation surrounding ESG factors. Whereas the European Union has committed to leading the global fight against climate change, U.S. policymakers have been divided on this issue. The U.S. Department of Labor (DOL) continues to vacillate on its guidance surrounding this issue (dependent largely on which political party is in office), thus making it difficult for investors to get complete clarity on the matter. The current guidance allows plan sponsors to treat social policy issues like any other economic consideration when those issues present material business risks or opportunities that companies need to manage as part of their respective business plans. While some investor groups view the Business Roundtable announcement as a publicity stunt and perhaps an effort to stave off future regulation, expanding the scope of corporate fiduciary duty will result in ESG factors becoming a routine part of corporate disclosures. In fact, over 80% of S&P 500

Exhibit 1: S&P 500 Companies Producing Annual Sustainability Reports



Source: Governance & Sustainability Institute Research Results

companies already produce annual sustainability reports.[2] As these disclosures continue to get priced into the market, the murkiness surrounding the DOL's fiduciary guidance should dissipate.

Investor demand will also continue to shape these disclosures. Looking back at the composition of the S&P 500, most companies in 1975 were commodities-driven businesses with values comprised of tangible assets. These raw materials, inventory, and equipment play less of a role in today's corporate balance sheets as the rise of technology has fueled a reliance on intangible assets; in 2018, intangibles made up 84% of company value for S&P 500 companies.[3] Unlike their tangible counterparts, intangible assets tend to be difficult to value, meaning the traditional valuation metrics may not be capturing the full picture. To resolve this, many investment managers have started to integrate ESG factors into their risk analysis process, oftentimes leveraging industry materiality frameworks (e.g., SASB Standards) to develop a more holistic assessment of a company's value. As a result, there has been an increase in demand for corporate disclosures around ESG concerns. The rise of passive investments has also magnified the need for corporate disclosure of ESG factors. As investors have given greater weight to these issues, those with passive exposure (where divestment is not an option) have turned to corporate engagement to influence behavior and improve overall shareholder value, the focus of which is on disclosure.

ESG REPORTING

One of the long-standing issues surrounding ESG integration has been finding a method to define these factors consistently across companies in a manner that can be easily translated to investors. In recent years, the UN's Sustainable Development Goals (SDGs) have emerged as one option for resolving this issue and have become the leading framework for reporting, serving as the "universal language" when incorporating ESG into the investment process at the company level (corporate responsibility), the asset manager level (ESG evaluation criteria), and the plan sponsor level (ESG considerations incorporated into the investment policy statement). The 17 SDGs were laid out and agreed to as part of the 2030 Agenda for Sustainable Development to eradicate poverty and address a range of social needs while tackling climate change and environmental protection.

Exhibit 2: The SDGs Provide a Framework for ESG Integration

Source: United Nations

OUR APPROACH

While ESG integration in the U.S. is at an earlier stage of development compared to Europe, the growing interest in this space presents an opportunity for investment managers to accumulate assets (at a higher fee), making greenwashing[4] an inevitable concern. At Marquette, our research team incorporates ESG into the evaluation process across all managers. We also have a dedicated Sustainable Investing Group comprised of members of our research and consulting teams to oversee the due diligence process for ESG-mandated strategies. When evaluating ESG integration, we incorporate the following best practices:

1. **Policy**: We look for managers with clearly defined frameworks surrounding sustainability that are incorporated into the investment process. We also consider it equally important to verify there is adequate compliance monitoring in place, as headline risk is a real concern for clients.
2. **Resources**: We look for managers with dedicated personnel focused on ESG integration as part of the investment process. We also prefer managers that develop their own research and ESG scoring system over those that rely solely on third party data.
3. **Engagement**: We look for managers with dedicated personnel focused on corporate engagement to increase shareholder value. We also prefer managers that can demonstrate how their firm "walks the walk" in terms of incorporating sustainable practices into their own business models.
4. **Reporting**: We look for managers that can provide clients with measurable impact reporting, including corporate engagement and proxy reporting.

ESG integration represents a new frontier and opportunity for asset managers and asset owners to add value to their portfolios; these strategies offer the ability to add financial return alongside social impact. Marquette will continue to evolve our practices to adequately address these issues for our clients and serve as a resource for those clients wishing to gain a better understanding of ESG integration within their portfolios.

NOTES

[1] CoreData Research
[2] Governance & Sustainability Institute Research Results
[3] 2019 Intangible Assets Financial Statement Impact Comparison Report
[4] The term "greenwashing" refers to the process of conveying a false impression or providing misleading information about how a company's products are more environmentally sound.

PREPARED BY MARQUETTE ASSOCIATES

180 North LaSalle St., Ste. 3500, Chicago, Illinois 60601 PHONE 312-527-5500
CHICAGO BALTIMORE MILWAUKEE PHILADELPHIA ST. LOUIS WEB marquetteassociates.com

The sources of information used in this report are believed to be reliable. Marquette Associates, Inc. has not independently verified all of the information and its accuracy cannot be guaranteed. Opinions, estimates, projections and comments on financial market trends constitute our judgment and are subject to change without notice. This material is not financial advice nor an offer to purchase or sell any product. References to specific securities are for illustrative purposes only and do not constitute recommendations. Past performance does not guarantee future results.

About Marquette Associates

Marquette Associates is an independent investment consulting firm that guides institutional investment programs with a focused client service approach and careful research. Marquette has served a single mission since 1986 – enable institutions to become more effective investment stewards. Marquette is a completely independent and 100% employee-owned consultancy founded with the sole purpose of advising institutions.
For more information, please visit www.marquetteassociates.com.