STERLING
CAPITAL ADVISORY SOLUTIONS

WHITE PAPER | **ESG —** Environmental, social and governance investing

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ESG:
From Niche to Mainstream

Once considered a niche market for institutional investors, environmental, social and governance (ESG) investing has gone mainstream. What exactly is ESG investing? Also called sustainable investing, the most commonly used definition is, “an approach to investing that aims to incorporate environmental, social and governance factors into investment decisions, to better manage risk and generate sustainable, long-term returns.”

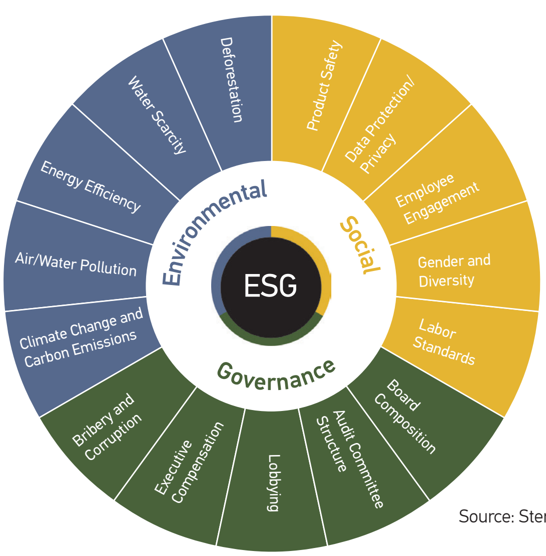
Definition and underlying characteristics

Each ESG factor has its own definition and underlying characteristics as illustrated in Figure 1. The “E” covers themes such as climate risks and natural resources scarcity. The “S” includes labor issues and product liability risks such as data security, while the “G” encompasses items such as business ethics and executive pay.

Figure 1.
EXAMPLES OF ESG CRITERIA USED BY SUSTAINABLE INVESTORS

The idea and implementation of ESG investing can be felt from all facets of the investment world. Today, more than $22.8 trillion is invested sustainably, representing more than $1 in every $4 under professional management.[1] We now see that 85% of companies in the S&P 500 Index published a sustainability/corporate responsibility report in 2017 (up from 20% in 2011).

Mutual funds are now incorporating ESG factors into their research process. Most investment managers have historically used some part of the ESG framework in their investment process – most notably the “G,” but the “E” and “S” have now become a significant focus. Money managers have well-defined policies and procedures in place to articulate their respective ESG research process.



Source: Sterling Capital

Our View

As ESG investing becomes commonplace, it is important to recognize the investment-related risks. Not all investments are created equal; therefore, having a thorough due diligence process is paramount in selecting the appropriate ESG product.

The Advisory Solutions team advocates for sustainable investments but we remain steadfast on building portfolios using a comprehensive, time-tested approach.

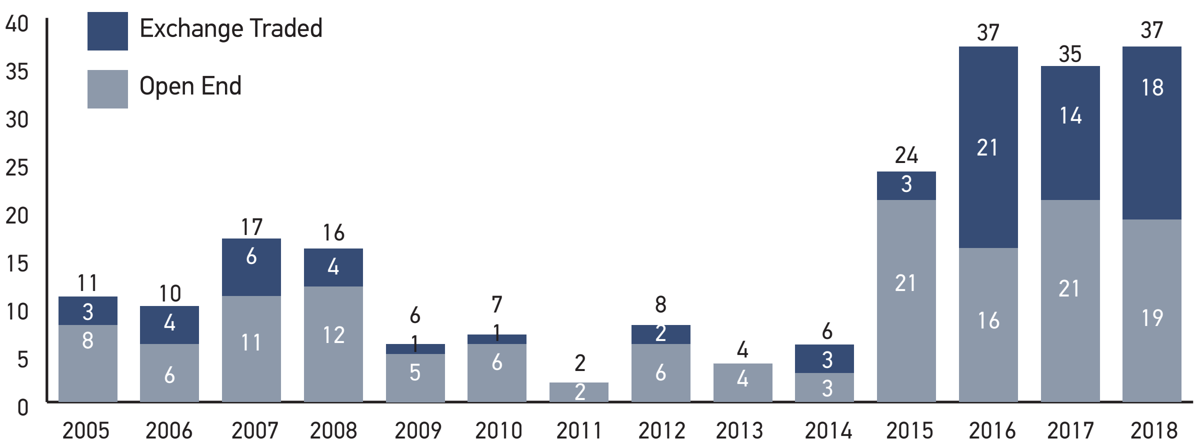
The Evolution of ESG

ESG investing started back in the 1960s when investors were excluding companies that provided weapons used in the Vietnam War. In the 1970s, activism spread but it was not until the 1980s that the first ESG fund was launched. At that time, the style of investing was referred to as socially responsible investing (SRI) which excluded certain investments, such as tobacco or guns. SRI still exists in a limited fashion but the investment philosophy has evolved to ESG which includes environmental, social and governance factors into investment decisions.

The ESG market is growing (and fast) with the asset base having jumped 38% since 2016. It is safe to say that asset managers and investors have taken notice. In 2018, Morningstar reported the number of ESG mutual funds and ETFs increased by 50%. The number of ESG products that came to the market in 2018 tied 2016 for the most funds launched in a calendar year (figure 2). For asset managers, climate change was the most important specific ESG issue considered. For institutional asset owners (pensions, foundations, etc.), conflict risk was the top specific ESG criteria, followed by tobacco, carbon/climate change, board issues, and executive pay.[2]

Figure 2.

SUSTAINABLE FUND LAUNCHES: A MULTIYEAR GROWTH TREND



Source: Morningstar Direct. Data as of 12.31.2018.

For all the new supply of funds coming to the market, demand for ESG is now starting to pick up. Annual net flows into ESG products from 2013-2018 have been more than 30 times higher the average net inflow from 2009-2012. The total assets under management for these funds reached $161 billion at the end of 2018.

While the growth in the U.S. is gaining steam, the concept (and more so the implementation) of ESG has been in existence overseas for years. More than half of the funds in Europe and Australia include ESG criteria, followed by Canada nearing 38%. Domestically, 22% of the funds in the U.S. utilize ESG criteria.[3]

Our View

Just a few years ago, the conversation around ESG was more conceptual with few assets actually moving into the space. Today, it is north of a $22 trillion market and Morningstar reported that sustainable funds pulled in nearly $5.5 billion in net flows in 2018. This marks the third consecutive year of record annual net flows. This is in contrast to the U.S. fund universe which saw its lowest calendar-year flows since 2008.

The growth in the space is both meaningful and unwavering with a large survey finding 84% of institutional investors are at least "actively considering" integrating ESG criteria into their investment process, with nearly half already integrating it across all their investment decisions.[4]

We should note that sustainable investing on a large scale is still in its infancy. Approximately 60% of asset owners that have integrated ESG into their investment process have begun doing so within the last four years and 37% within the last two.5 As a result, it is important not to rush allocating to any investment and allow time to conduct comprehensive due diligence. As stated earlier, not all investments are created equal and the first fund to the market does not mean the best.

Our View

There is no denying the growth of sustainable investing and the millennials impact on the space. With millennials poised to receive more than $30 trillion of inheritable wealth, demand for sustainable investments will continue to grow. We anticipate both asset managers and advisors to adjust to a generation that is now the largest in the U.S. labor force, accounting for 35% of American labor force participants.[7]

Why the Increase in ESG?

A natural next question may be: what is driving this growth? Research has found not what but instead who is driving the growth. Multiple studies have been conducted to ascertain the drivers of growth and while results on the specifics may vary, one outcome is undeniable – millennials are driving force behind ESG investing.

For example, a recent study from Morgan Stanley[6] found:

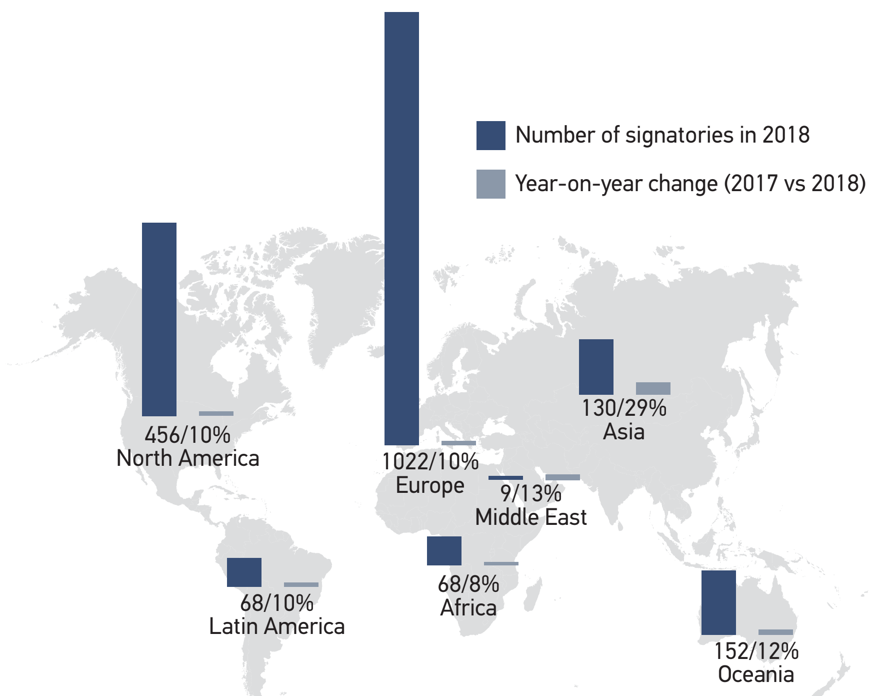
- 84% of millennials cite investing with a focus on ESG impact as a central goal.
- Millennial investors are nearly twice as likely to invest in companies or funds that target specific social or environmental outcomes.
- 29% of investors in their 20s and 30s seek a financial advisor that provides values-based investing.
- 17% of millennials indicate they seek to invest in companies that use high quality ESG practices, compared with 9% of non-millennial investors.

Uniformity

While definitions and implementation practices of ESG vary, there is been a level of uniformity set forth by the United Nations-supported Principles for Responsible Investment (PRI) Initiative. Established in 2006, the PRI is a public-private partnership by which investment managers and asset owners can become a signatory. If the entity chose to become a signatory, they are asked to put the following six Principles for Responsible Investment into practice:

1. Incorporate ESG issues into investment analysis and decision-making processes.
2. Be active owners and incorporate ESG issues into ownership policies and practices.
3. Seek appropriate disclosure on ESG issues by the entities in which they invest.
4. Promote acceptance and implementation of the Principles within the investment industry.
5. Work together to enhance the effectiveness in implementing the Principles.
6. Report on activities and progress towards implementing the Principles.

Figure 3.
PRI SIGNATORIES REGION BREAKDOWN AND INCREASE AGAINST 2017



These principals are evaluated annually and signatories are given a report to assess their progress. The PRI Initiative has become the leading global network for investors to publicly demonstrate their commitment to responsible investment. Today, there are over 2,000 investment managers and nearly 400 asset owners worldwide (Figure 3).

In Washington, D.C., lawmakers are seeking to develop a law that would standardize the sustainability data that companies report, which could help investors more easily compare securities. As previously mentioned, 85% of companies now generate a sustainability/corporate responsibility report , however, much of the information they report is in a format inconsistent with other firms. This would provide uniformity.

Performance Penalty?

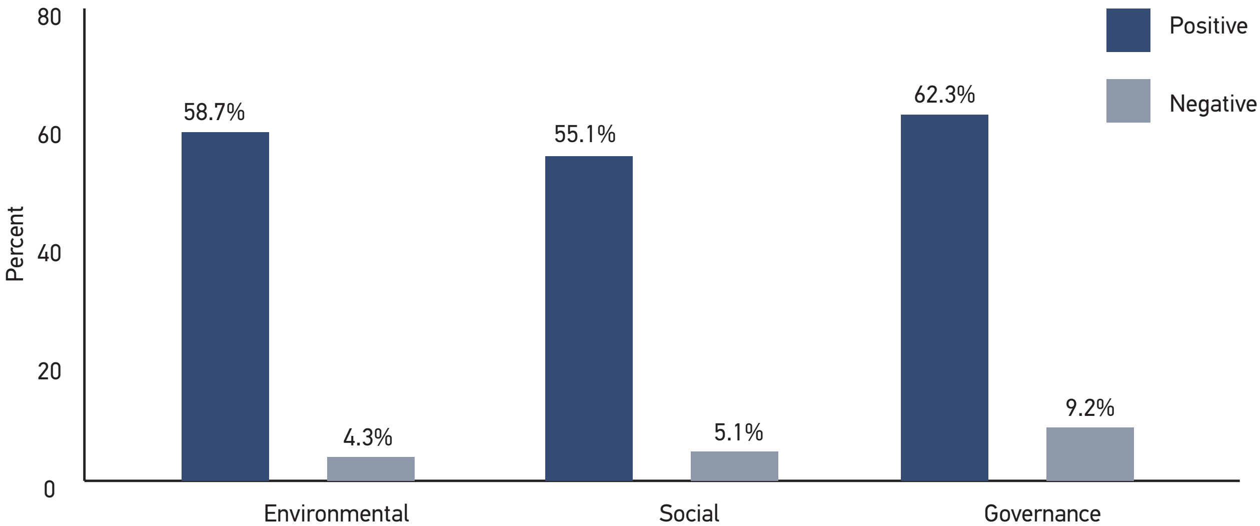
Arguably the biggest criticism relating to ESG investing is performance. Many believe that investing sustainably requires a financial trade-off. The numbers do not necessarily support that hypothesis.

ESG through its original incarnation of SRI has been around for decades. Going back to 1970, empirical studies show incorporating ESG factors is positively correlated to financial performance. Figure 4 illustrates these findings by examining the positive and negative correlations to financial performance of the "E", "S" and "G" components.

Figure 4.

CORRELATION OF ESG FACTORS TO FINANCIAL PERFORMANCE

PERCENT OF TOTAL STUDIES THAT FIND CORRELATION TO FINANCIAL PERFORMANCE



EMPIRICAL STUDIES SHOW INCORPORATING ESG FACTORS IS POSITIVITELY CORRELATED TO FINANCIAL PERFORMANCE.

Source: Neuberger Berman; Fried, G., Busch, T., & Bassen A. (2015)

More recently, the mass utilization of ESG investing and the proliferation of mutual funds and ETFs gives further credence to the strong performance of ESG investing.

As reported by Morningstar, sustainable funds, on average, outperformed on a relative basis in 2018. More specifically, 63% of sustainable funds finished in the top half of their respective categories, including 35% in the top quartile. Only 37% of strategies finished in the bottom half, including just 18% in the bottom quartile.

On the strength of last year's returns, 57% of sustainable funds now rank in the top half of their categories over the trailing three years. For the trailing five years, 58% rank in their category's top half.

Ultimately, the track record of sustainable fund performance is consistent with the findings of academic research.

Our View

Investment managers and asset owners have historically created their own definitions and apply those principles in their own unique fashion. PRI provides commonality not only to a specific fund but the entire firm. The organizations ongoing due diligence is paramount to ensure asset managers are executing upon the PRI philosophies. The overwhelming majority of managers that classify their funds as ESG have become PRI signatories and we expect additional firms to commit. It has quickly become a leading member of the ESG community.

As the Advisory Solutions team creates portfolios based on ESG values, the PRI guidelines are important but they are only one set of principles. We look for managers that have ESG fully engrained the fund's DNA and fully implemented throughout the process. It is important to recognize that definitions and approaches may differ but the values of ESG investing, along with seeking strong performance, are the guiding principles.

Our View

Past results are one element of determining future outperformance. With new funds coming to the market, analyzing historical returns with short track records can be tough. Even harder is evaluating future outperformance of a fund that was recently repurposed to include ESG criteria. The inability to properly evaluate investment manager performance can ultimately result in sub-optimal outcomes for investors. Conventional performance evaluation methods (e.g., over-emphasis on point-in-time trailing returns; establishing arbitrary time periods in which a strategy should outperform) have generally failed investors over time.

Sterling Capital's Advisory Solutions Team employs a thoughtful, disciplined and repeatable approach to investment manager performance evaluation that considers factors beyond traditional evaluation methods. Importantly, when selecting a manager, historical performance should be a minor consideration in the early stages of the due diligence process.

We use the "5-Ps" process when conducting due diligence which looks at all facets of a fund. One of the "Ps" is performance but an emphasis is also placed on the People, Process, Philosophy and Partnership. This analysis is certainly required in the initial due diligence phase but ongoing surveillance of each of the "5-Ps" is equally important.

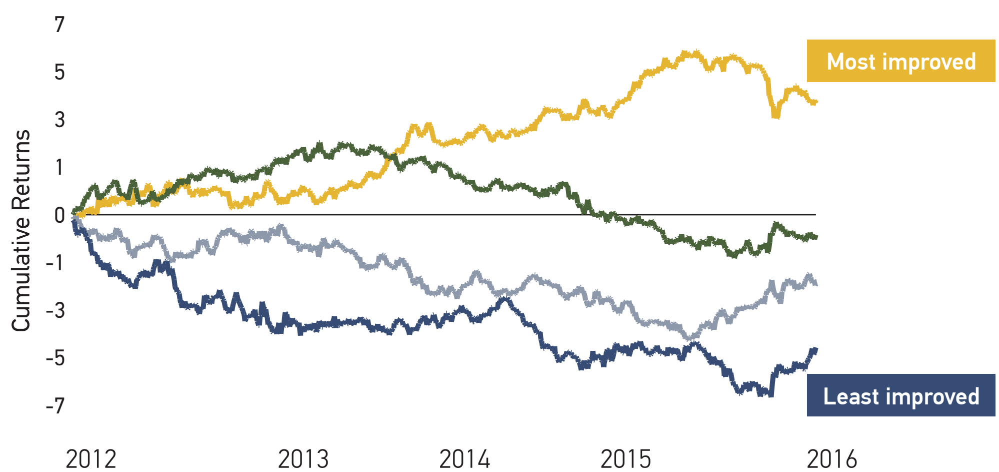
However, there are cautions when evaluating performance of an ESG fund.

First, it should be noted ESG mutual fund and ETF adoption by the masses is a fairly recent phenomena. The proliferation of these new vehicles is both organic and artificial. There are new funds coming to the market, which has created steady and robust organic growth. A closer look at the data reveals that not all "new" ESG funds are actually "new," in fact, some may be artificial. Of all the ESG funds that came to the market last year, 63% came from funds currently in existence but added ESG criteria to their prospectuses.

The second caveat relates to an earlier comment about each manager having their own definition of ESG. In a recent meeting, a 2018 study was highlighted to show the performance benefits of ESG investing. The chart below was presented.[8] It highlighted carbon efficiency and breaking stocks into five categories, ranking them from "most improved" to "least improved." A few things stood out. As illustrated, those stocks that were "most improved" clearly outperformed other segments, with the "least improved" as the worst performers. However, ESG is a broad space and this study isolates carbon. While carbon is an important factor, it is only one factor. In fact, carbon is only a factor within the "E" of ESG. This study eliminates other aspects of the "E" as well as the entire social ("S") and governance ("G") factors.

Further, the time frame of this study is from 2012 to 2018. Reviewing only a small sample of performance can be very misleading and may not give the full representation of true performance.

Figure 5.
EVALUATING PERFORMANCE OF AN ESG FUND



Source: Garvey, G. et al. (2018). Carbon Footprint and productivity: does the "E" in ESG capture efficiency as well as environment? Journal of Investment Management, Vol.16, No. 1, pp. 59-69; BlackRock (2016). Adapting portfolios to climate change. BlackRock Investment Institute.

So, is the criticism of performance valid? Perhaps there should not be a performance penalty but instead a time penalty as the majority of funds in this space has not "lived" through multiple market cycles.

About Sterling Capital Management

Sterling Capital Management LLC is a registered investment advisor founded in 1970, with more than $56 billion in assets under management.[9] The firm is an independently operated subsidiary of BB&T Corporation, one of the nation's largest financial services holding companies. Headquartered in Charlotte, NC, Sterling Capital is comprised of more than 160[10] professionals located in Charlotte and Raleigh, NC; Philadelphia, PA; Richmond and Virginia Beach, VA, Washington, DC; and San Francisco, CA.

With almost 50 years of experience in active management, our results and investment expertise reflect an unwavering commitment to finding the best, most durable investment opportunities for our clients in the years ahead.

Sterling Capital offers investment services across a variety of asset classes and structures such as Fixed Income, Equity, and Multi-Asset Class solutions. At Sterling Capital, we are dedicated to providing strong risk-adjusted investment returns and exceptional client service for a diverse group of institutional and private clients. *Pensions & Investments* magazine ranked Sterling Capital No. 121 in terms of the firm's size out of 528 managers tracked in its 2019 "Largest Money Managers" report.[11]

[1] The Forum for Sustainable and Responsible Investment: https://www.ussif.org/sribasics

[2] The Forum for Sustainable and Responsible Investment: https://www.ussif.org/files/US%20SIF%20Trends%20Report%202018%20Release.pdf

[3] Global Sustainable Investment Alliance: http://www.gsi-alliance.org/wp-content/uploads/2017/03/GSIR_Review2016.F.pdf

[4,5] Morgan Stanley: https://www.morganstanley.com/assets/pdfs/sustainable-signals-asset-owners-2018-survey.pdf

[6] Pew Research: https://www.pewresearch.org/fact-tank/2018/04/11/millennials-largest-generation-us-labor-force/

[7,8] Sustainable investing: the millennial investor: https://www.ey.com/Publication/vwLUAssets/ey-sustainable-investing-the-millennial-investor-gl/$FILE/ey-sustainable-investing-the-millennial-investor.pdf

[9,10] Data as of June 30, 2019.

[11] *Pensions & Investments* (www.pionline.com) 46th annual "Largest Money Managers" report 2019. Published May 27, 2019.

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