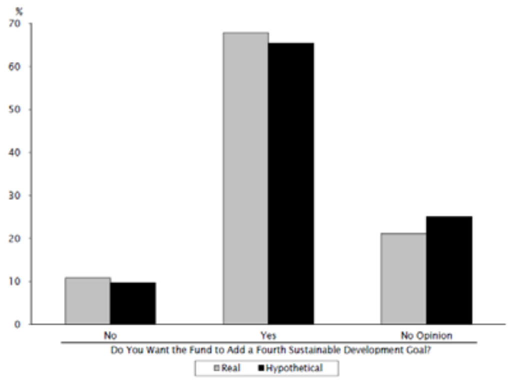
Institutional Preference for ESG Investing

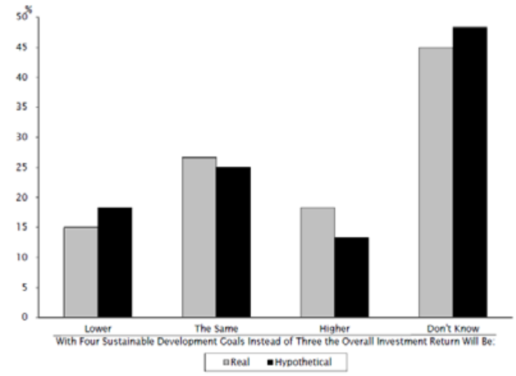
Exhibit 27: Investors in a Large Dutch Pension Fund
Share of Respondents Who Wanted to Add a Fourth Sustainable Development Goal
By Treatment[1]
June 2018



Source: Bauer, R., Ruof, T., and Paul Smeets, 2018. "Get Real! Individuals Prefer More Sustainable Investments." Working Paper.

[1] In the real treatment investors were told their vote was binding and the pension fund would implement the majority decision; in the hypothetical treatment they were told the pension fund was interested in their opinion.

Exhibit 28: Investors in a Large Dutch Pension Fund
Share of Respondents Who Believe Adding a Fourth Sustainable Development Goal Will Increase Returns
By Treatment[1]
June 2018



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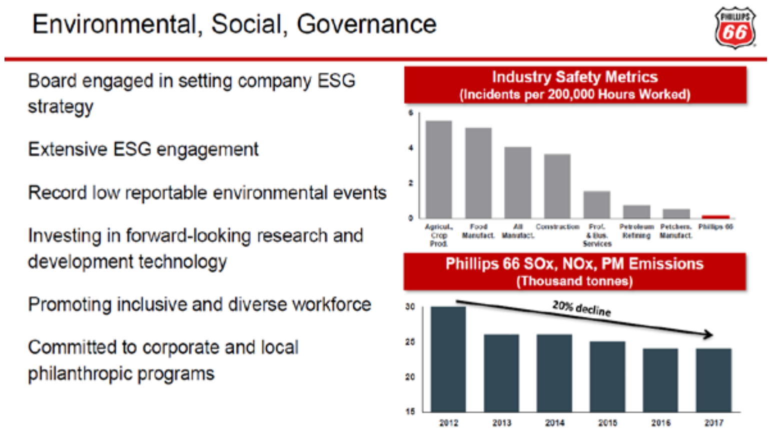
Source: Empirical Research. Dutch pension fund members votes for ESG investing (left) and return expectations (right)

"One Sterling" is a phrase our firm uses to describe the benefits of working together for the interest of our clients. This effort was evident this past month as we integrated contributions from our Charlotte, Philadelphia, and Virginia Beach equity teams on a recent investment decision. By combining intellectual curiosity, a collaborative approach, and a desire to maximize client outcomes, we continue to scrutinize investment candidates using various perspectives within our long-standing investment process.

The origins of ESG (Environmental, Social, and Corporate Governance) have been in place for some time with large consultants such as Mercer noting, "the firm established its responsible investment practice in 2004." Yet even now, definitions of ESG can differ across firms. A recent Forbes article noted "there are 150 different reporting metric systems in place, with none being the overwhelming framework or rating system of choice." This month, Sterling investment team members from Sterling's Relative Value and Equity Opportunities teams visited and met with senior management of SEI Investments, a portfolio holding and administrator of $564 billion in assets. SEI management noted that 70% of their managers use ESG as part of their selection process due to increasing demand from their institutional clients as seen in the chart above where recent academic studies have provided confirmation.

Bob Bridges from Sterling's Focused Factor team based in Charlotte has contributed greatly to the firm's ESG effort. His work echoed comments from SEI that most investors can agree on good governance, but as Empirical Research states, "the E and the S often veers into the realm of partisan politics." For example, is a unionized workforce a positive? These components are also challenged by a lack of data. Presently, only 18 out of 80 large cap software companies report what percent of their workforce is female. Should Alphabet and IBM be penalized for disclosing below average percentages yet disclose the data? The Charlotte team's work does point to the benefit of ESG awareness as the lowest ranked stocks tend to underperform over time. This is confirmed by Empirical Research's work that notes, "companies with favorable ESG credentials tend to have predictable and higher quality earnings, are lightly shorted, have lower capital intensity, return capital to shareholders whenever they can, and generally trade at lower multiples."

If you sense a similarity between Empirical's observations and the Equity Opportunity Group's



Source: Company Reports

investment pillars, you may be onto something. In fact, if investors performing due diligence on our Equity Income strategy look at its Morningstar Sustainability Ranking™*, they will find it has the highest possible ranking. As ESG definitions continue to crystalize, we have found it helpful that our investment process is consistent with this phenomenon.

But how do we integrate these principles and inputs across Sterling's research resources and beyond our investment pillars and into the "secret sauce" of our fundamental analysis and security selection? We'd highlight our recent purchase of Phillips 66 in the Equity Income portfolio as an example. While one may not initially view an energy refining company as ground zero for ESG considerations, investors may want to recall the loss in market capitalization in stocks such as deepwater driller Transocean after the Deepwater Horizon explosion. In 2017, Phillips 66 received the Greenovations Award by the U.S. Environmental Protection Agency for its environmental stewardship. Yet our research work notes additional positive changes and enhanced ESG disclosures in their 2017 proxy statement especially around "reputational risks." A slide from their recent investor presentation is provided above, but the combination of enhanced governance, and focus on "low reportable environmental events" simply seems like solid risk reduction policy and good business. While some investors have laudable goals to change the world, we see ESG investing as investing.

As always thank you for your interest and trust managing your investments.

Chip Wittmann, CFA®
Executive Director
(757) 417-4901
cwittmann@sterlingcapital.com

**The Morningstar Sustainability Rating™ is a measure of how well the holdings in a portfolio are managing their environmental, social, and governance, or ESG, risks and opportunities relative to their Morningstar Category peers. The rating is a holdings-based calculation using company-level ESG analytics from Sustainalytics, a leading provider of ESG research. It is calculated for managed products and indexes globally using Morningstar's portfolio holdings database.*

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