The only constant is change.
—sometimes attributed to Heraclitus of Ephesus

As of April 2015 the signatory base of the United Nation’s Principles for Responsible Investment (UNPRI) had reached $59 trillion of assets under management or roughly half of the world’s institutional assets.¹ Not all signatories have achieved the same level of portfolio alignment with respect to the UNPRI core principles, but the number and size of the initiative’s signatory base nevertheless represents a strong indication of industry interest and aspiration.²

As another measure of interest, according to the biennial landscape review conducted by the Global Sustainable Investment Alliance, as of 2014 responsible investment (RI) techniques as broadly defined were used to manage more than 30 percent of global assets.³ This is up from 21.5 percent in 2012. In the United States, the total is only 17.9 percent, but this is up from a much smaller base of 11.2 percent, making it the fastest growing RI market in the world, though it still lags significantly in terms of adoption rates in other markets (e.g., Europe, where the total is now nearly 60 percent).

Nevertheless, the RI market faces some strong headwinds in particular in the U.S. marketplace, where confusion around terminology, concerns over fiduciary duty, and doubts about the financial performance case for RI. Perhaps more importantly, if these clarifications are not enough to dispel persistent skepticism regarding the financial merits of RI, the article concludes with a series of questions that investors can answer to determine their own conviction with respect to the influence of ESG factors on portfolio risk and return and investor reputation. With these convictions established, investors will be better positioned to plan for and react to change.

Challenges
Terminology
The UNPRI defines responsible investment as the following:

"Responsible investment is an approach to investment that explicitly acknowledges the relevance to the investor of environmental, social and governance (ESG) factors, and of the long-term health and stability of the market as a whole. It recognises that the generation of long-term sustainable returns is dependent on stable, well-functioning and well governed social, environmental and economic systems."

The PRI is certainly prominent in the growing RI movement, but its characterization above hasn’t yet reached consensus, meaning some core definitional issues persist. The most unfortunate example of this is the acronym SRI, which has been construed to mean many different things over the past few decades including:

- socially responsible investment
- sustainable and responsible investment
- sustainable, responsible, impact investment
- socially responsible impact investment

Each of these terms has different implications and can have salient differences in application, though today the term “socially responsible investment” is most common (and will be referred to as SRI here). But the confusion doesn’t stop there.

To establish a foundation of common understanding, a working taxonomy of RI terminology based on current best practices and usage is included in table 1. In short, RI, also known as sustainable investment, is an umbrella term meant to encapsulate all forms of investing that use ESG criteria to make investment determinations. These criteria can be applied as a screen (negative or positive) or be fully integrated into the investment valuation process. Table 2 lists various RI approaches and techniques.

Confusion over terminology may not hinder adoption of RI, but it has led to some erroneous views about RI performance. The most obstructive issue is the conflation of SRI, which relies largely on negative screening or exclusion of specific assets, with RI, which represents a broad mix of investment techniques.

Fiduciary Duty
According to West’s Encyclopedia of American Law, a fiduciary is an “individual in whom another has placed the utmost trust and confidence to manage and protect property or money.”⁵ Fiduciary duty then is the relationship where the fiduciary has an obligation to act for another’s benefit.

According to the UNPRI, on the subject of fiduciary duty as it relates to ESG integration, there is very limited case law in the United States to inform investor action.
### Table 1: A Taxonomy for Responsible Investment Approaches

<table>
<thead>
<tr>
<th>Investment Type</th>
<th>Conventional Investment</th>
<th>Responsible Investment</th>
<th>Philanthropy</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Description</strong></td>
<td>No explicit focus on ESG factors.</td>
<td>Largely negative screening performed to align investments with ethical or moral considerations (also known as values investing or faith-based investing if driven by religious values). Applicable to all asset classes.</td>
<td></td>
</tr>
<tr>
<td><strong>Socially Responsible Investment (SRI)</strong></td>
<td>Positive screening and/or fully integrating ESG factors into the investment process to capture alpha or manage beta. Applicable to all asset classes.</td>
<td>Investments in sectors or subjects with sustainability themes such as water, renewable energy, sustainable timber/agriculture, etc. Applicable to all asset classes, though most familiar in private-market vehicles.</td>
<td>Grants</td>
</tr>
<tr>
<td><strong>Environmental, Social, and Governance (ESG) Investment</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Thematic Investment</strong></td>
<td></td>
<td>Defined by the Global Impact Investing Network as investments made with the intention to generate measurable social and environmental impact alongside a financial return. In practice these largely take the form of local, private-market investments targeting specific sectors, geographies, or demographics (subcategories include place-based or community investing).</td>
<td></td>
</tr>
<tr>
<td><strong>Impact Investment (includes Place-Based/Community Investment)</strong></td>
<td></td>
<td>Mission-Related Investment</td>
<td></td>
</tr>
<tr>
<td><strong>Investment</strong></td>
<td>Program-Related Investment</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Active Ownership‡</strong></td>
<td>Some conventional investors would be considered activists, but their focus is not usually on ESG issues.</td>
<td>Voting and engagement techniques are often used by SRI investors alongside negative screens.</td>
<td>Voting and engagement techniques are often used in conjunction with positive screens or ESG integrated strategies to compel progress on ESG issues by the securities issuers.</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>Emphasis on risk/return depends on the strategy. Engagement is central to many private equity strategies.</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>See commentary under thematic investment.</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>Highly dependent on specific program-related investment and investor strategy.</td>
</tr>
</tbody>
</table>

*See http://www.thegin.org/impact-investing/need-to-know/#s1.
† U.S. IRS rules governing program-related investment recently were clarified; see https://www.federalregister.gov/articles/2012/04/19/2012-9468/examples-of-program-related-investments#h-15.
‡ Includes the activities of proxy voting (public equity only) and engagement (all asset classes).

### Table 2: Responsible Investment Approaches and Techniques

<table>
<thead>
<tr>
<th>General Approaches</th>
<th>Specific Techniques</th>
</tr>
</thead>
<tbody>
<tr>
<td>Socially Responsible Investment (aka Ethical, Values-Based, or Faith-Based Investment)</td>
<td>Negative Screening/Exclusionary</td>
</tr>
<tr>
<td>Mission-Related Investment and Program-Related Investment</td>
<td>Positive Screening/Best-in-Class</td>
</tr>
<tr>
<td>ESG Investment</td>
<td>ESG Integration</td>
</tr>
<tr>
<td>Thematic Investment</td>
<td>Proxy Voting and Engagement (together with Active Ownership)</td>
</tr>
<tr>
<td>Impact Investment (includes Place-Based/Community Investment)</td>
<td></td>
</tr>
</tbody>
</table>

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Specifically, in determining fiduciary negligence there is some confusion whether the soundness of investment processes followed matters more or less than the investment outcomes achieved (theory favors the former but uncertainty prevails). It’s also unclear what constitutes a material investment issue in terms of risk/return and over what timeframe performance analysis should take place to determine materiality (both duration and whether retrospective or prospective).6

Fiduciary responsibility also may be interpreted in a narrow sense as requiring fiduciaries to seek to maximize financial returns for beneficiaries. This could create a perception that consideration of ESG factors, which are often described as being “nonfinancial” in nature, conflicts with fiduciary duty. This descriptor is accurate in a sense—ESG factors typically are not expressed in dollar terms—but it is misleading because it does not consider how such second-order factors can be and are treated in financial analysis.

There are numerous examples of defensible statistical approaches to the assessment of the financial implications of ESG factors.7 This approach aims to make investors feel more confident in treating a host of ESG issues as quantitative risk factors rather than qualitative uncertainties when it comes to portfolio construction.

When addressing concerns regarding fiduciary duty and ESG investing, it may be helpful to take a common-sense approach to considering the following implications of new information:

**Information is power in investing.** Accessing new sources of information and/or analyzing information in new ways are about the only ways to gain an advantage in investing. The growing onrush of ESG data presents enterprising investors with a host of opportunities for innovation when it comes to the qualitative evaluation as well as the quantitative valuation of securities.

**The risk of regulation is real.** The potential for government intervention on ESG issues (e.g., to combat the worst effects of climate change) is real. If markets respond to other forms of prospective government intervention (e.g., monetary policy), potential regulation of ESG issues should be no different.

Uncertainty around the legal interpretations of fiduciary duty and ESG investment in the United States may have hindered historical investor action. As of February 2016, 24 asset owners and 199 asset managers based in the United States had signed the UNPRI. This represents less than 20 percent of the global signatory base.8

**Performance.** One of the key concerns holding back the growth of the RI market in the United States is the persistent view that adopting any such techniques necessarily will result in a performance penalty. This is grounded in the history of several ethically motivated SRI movements over the past several decades that showed negative returns.9

This conflation of SRI with RI, however, is inappropriate. But, because of the variety of techniques used, measuring the performance of RI generally is challenging. Thus the following commentary focuses on the two most-prominent RI techniques in use today—negative screening (i.e., SRI) and ESG integration.

SRI has a longer history than ESG integration, and because of its binary nature it is in many ways easier to analyze than ESG integration. However, SRI investors define their exclusion criteria in various ways based on various value systems, and the same exclusions can be applied quite differently (e.g., a screen based on companies with 5 percent of associated revenue sometimes will yield surprisingly different net results than a 10-percent revenue threshold). So in SRI the performance case hinges largely upon the theme or activity being excluded, the threshold for exclusion, the portion of the subject universe represented by this exclusion, the timing of the exclusion, the timeframe over which relative performance is measured, the performance metrics used, active versus passive mandates, etc.

Figure 1 shows the results of a recent meta-analysis that controlled for many of these factors.10 The meta-analysis examined a sample of 35 studies comparing SRI vehicle performance to conventional benchmarks. It found that “15 [studies] conclude that SRI vehicles perform in the same way as their conventional benchmarks, 6 find underperformance, and 14 exhibit outperformance compared to their various benchmarks.”

The preponderance of the studies represented in figure 1 that show a neutral or positive impact of negative social screens on performance would seem to present a compelling case for the relative performance of SRI fund strategies generally. However, in part due to the diversity of findings and approaches to measurement used, the authors find the performance case for SRI to be inconclusive.
A closer look at fossil fuels highlights the issue of time horizon for SRI performance analysis. Recent analyses of endowment and pension fund portfolios show the negative contribution of fossil fuel investments to overall returns over a short-term time horizon (usually one to three years).10 Competing studies show the positive contribution of fossil fuel stocks to overall returns over a longer-term time horizon (e.g., 20 years).12 The results of fossil fuel exposures appear to hinge largely upon the time frame; the past three years look poor whereas the past 20 look rosy.

Meta-analyses of ESG investing—of which there are many13—differ from those focused on SRI. First, most ESG studies focus on company-level performance rather than fund-level performance, reflecting the relative paucity of ESG funds available historically. However, one recent study concluded “sustainable (U.S.) equity funds had equal or higher median returns and equal or lower volatility for 64 percent of the period 2007–2014.”14 Most studies rounding out this body of research indicate a positive connection between long-term risk-adjusted investment returns and the integration of material ESG factors at the individual asset level.15

Regardless of the above analyses, proving the financial merits of ESG investing to long-term investors by using historical analysis is frustrated by the following:

Diversity of approaches. SRI and ESG are different and should not be assessed similarly.

Limited historical dataset. Reasonably sound ESG data are a decade old at most, and the indexing methodologies used are diverse.

Scale and level. Impact at the company level is fairly clear but less so at the multi-asset class portfolio level.

Risk vs. return. Financial influence varies depending on the performance metrics used and return tells only part of the story.

Time horizon. This is a particular challenge because many of the benefits of ESG investing approaches are prospective in nature (e.g., positioning a portfolio to withstand the adverse future impacts of climate change, a phenomenon with limited historical precedent) and thus difficult to capture retroactively.

Fundamentally, historical analysis neglects to capture the potential for future structural change from macro trends (e.g., climate change) that might impact sectors (e.g., the energy industry) or asset classes. This lack of prospective analysis tends to ground divestment and other ESG debates in moral (and often political) arguments about the future that can be intractable. Motivated in part by the desire to remove such roadblocks, recent research has tried to provide investors with a framework for assessing long-term, forward-looking, and complex ESG risks using quantitative and qualitative perspectives.16 Recent progress notwithstanding, the investment industry has a long way to go before more fulsome approaches to ESG risk analysis are mainstreamed.

Conviction
Given the strong though inconclusive evidence supporting the historical outperformance of SRI and ESG approaches, the decision to invest sustainably depends on conviction. Investors with long horizons who want to invest sustainably by considering ESG risks/opportunities ultimately need to be convinced about the future benefits afforded by such approaches (e.g., protection over the long-term against unprecedented future risks (e.g., climate change)). It is thus incumbent upon investors to determine their related beliefs.17 In developing such beliefs, investors first need to answer a series of difficult preliminary questions about the relationship of ESG factors to the “Three R’s”—risk/return, and reputation:

Risk/return. Based upon available knowledge, does the investor believe ESG issues are material to the risk/return profile of an investment? If not in general then in what specific contexts? Should active-ownership principles be used in an attempt to improve the ESG profile of specific investments?

Reputation. Could holding a set of securities that do not perform well on ESG factors impact negatively the reputation of an investor among its stakeholders? Should active-ownership principles be used in an attempt to influence outcomes among potentially offensive holdings or would divestment be more appropriate?

In attempting to answer these broad questions, investors inevitably will run into a...
host of subordinate though equally important questions (e.g., over what timeframe should our determination of materiality take place? Which ESG issues should be prioritized at the portfolio, asset class, and industry sector levels? What level of internal resource expenditure is appropriate with respect to ESG given the potential benefits?).

The ESG landscape is diverse and complex. The process of determining a sustainable investment pathway that is right for an organization is as much subjective as it is objective and therefore ripe for contention especially among diverse groups of people (e.g., institutional investor boards of directors or investment committees). For these reasons, having an impartial/independent guide to help an organization through the process of beliefs development may help. Regardless, as awareness and use of RI approaches and techniques grows and as the financial signal of various ESG issues becomes clearer, the organizations that have developed a strategic, proactive approach will be most agile and able to adjust to change, the only constant.

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Mr. Bernhardt’s views may not necessarily reflect those of his employer.

Endnotes


2. In joining the UNPRI each institution is required to sign a declaration, asserting as fiduciaries that “they believe that environmental, social, and corporate governance (ESG) issues can affect the performance of investment portfolios (to varying degrees across companies, sectors, regions, asset classes and through time).”

3. According to the Global Sustainable Investment Alliance, these techniques include the following activities and strategies: (1) Negative/exclusionary screening, (2) Positive/best-in-class screening, (3) Norms-based screening, (4) Integration of ESG factors, (5) Sustainability-themed investing, (6) Impact/community investing, and (7) Corporate engagement and shareholder action. See table 1 for a working taxonomy.

4. Credit for this list goes to Bruce Herbert at Newground Social Investment, http://www.newground.net/sri.asp.


6. This is a paraphrasing from the U.S. section of: UNPRI titled “Fiduciary Duty in the 21st Century”; see http://2xjmlj8428u1a2k5o34l1m71.wpengine. netdna-cdn.com/wp-content/uploads/Fiduciary-duty-21st-century.pdf. Note that on October 22, 2015, the U.S. Department of Labor issued Interpretive Bulletin 2015-01, which clarified the permissible consideration of ESG factors for economically targeted investments under the Employee Retirement Income Security Act of 1974. This represents a significant step forward in clarification on this subject, but the uncertainty in case law prevails.

7. For example, see Mercer’s “Investing in a Time of Climate Change” study, which includes a framework for quantifying the impact of climate change on a diversified portfolio of assets; see http://www.mercer.com/content/mercer/global/all/en/insights/focus/invest-in-climate-change-study-2015.html.


9. For example, a recent analysis shows how well tobacco companies and other sin stocks have performed versus ethically screened indexes; see Credit Suisse, Global Investments Return Yearbook 2015, “Responsible Investing: Does it Pay to be Bad?” https://publications.credit-suisse.com/tasks/render/file/?file-ID=AE904F44-E396-4A5E-11E6-3B08C6E27CCB.


16. Mercer’s “Investing in a Time of Climate Change” report is an example of recent research into portfolio-specific ESG risk. It provides a robust, transparent framework for holistic quantitative analysis of climate change impacts in financial terms at the portfolio, asset class, and industry sector levels; see http://www.mercer.com/our-thinking/investing-in-a-time-of-climate-change.html. Additionally, “A Broader Perspective on Risk” discusses the utility of supplementing quantitative portfolio reviews with qualitative, forward-looking perspectives on large or systemic risks both with and without historical precedent; see http://www.mercer.com/our-thinking/a-broader-perspective-on-risk.html.

17. For this reason, Mercer’s “Framework for Sustainable Growth,” which is used to guide investors toward integration of ESG into portfolios—starts with the development of RI beliefs; see http://www.mercer.com/insights/poin/2014/an-investment-framework-for-sustainable-growth.html.