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Sustainable investing is going mainstream. According to Morningstar, the number of environmental, social, and governance (ESG) funds grew by 50 percent during 2018 alone.[1] This is remarkable growth, and we expect it to continue. Accompanying this growth, we also are witnessing a debate over definitions and what constitutes a sustainable investment or investment approach, as well as a fair amount of confusion around what sustainable investing really is. In this article, we weigh in on that debate with the hope of replacing some of that confusion with clarity.

INTRODUCTION

We use "sustainable investing" to describe any attempt to construct investment portfolios that incorporate ESG factors into security analysis and selection and portfolio construction. The rationale for incorporating ESG factors into investment analysis and portfolio construction has two components, one economic and one normative.

ECONOMIC RATIONALE FOR ESG INVESTING

A substantial body of research suggests that ESG factors have materiality, and therefore some relevance to or bearing on how companies perform, and thus on how investment portfolios perform.

Research suggests that companies that are stronger environmental performers carry less risk, achieve greater efficiencies, and are better positioned than environmental laggards to take advantage of opportunities in a global marketplace where environmental issues increasingly matter. Similarly, companies with strong employee relations and workplace practices enjoy higher morale and productivity, lower turnover and absenteeism, and carry less risk and are better positioned for growth than their less-enlightened peers. Companies with gender-diverse leadership teams perform better than companies with fewer women in leadership. And companies with better corporate governance practices may be less likely to have blow-ups and reputational disasters and are simply better long-term investments than poorly governed companies.[2]

The transition to a more sustainable global economy will create both risks and opportunities that companies will need to navigate and investors cannot ignore. Companies that do a better job managing these risks and opportunities will be better positioned than their less nimble, less forward-thinking competitors to provide long-term investment performance. Therefore, combining rigorous financial analysis with equally rigorous ESG analysis is, in our view, simply a smarter way to build investment portfolios.

NORMATIVE RATIONALE FOR ESG INVESTING

The modern business corporation's license to operate charges it with delivering goods and services through a competitive marketplace that, in the end, is meant to produce economic growth and other societal benefits. At one time it was thought that the only duty of a corporation was to its shareholders or, in Milton Friedman's famous dictum: The only duty of a corporation is to make a profit. Today, a more expansive definition of the modern corporation holds that its duties extend to its shareholders and to other stakeholders as well—its employees and customers, the communities where it does business, and the natural environment.

Indeed, business corporations increasingly are expected to serve the public interest. This isn't just the persuasion of the sustainable investing community. Larry Fink, chief executive officer (CEO) of BlackRock, one of the largest mainstream asset managers in the world, noted in an annual letter to CEOs, "Unnerved by fundamental economic changes and the failure of government to provide lasting solutions, society is increasingly looking to companies, both public and private, to address pressing social and economic issues."

ANSWERING CRITICS OF SUSTAINABLE INVESTING

On the basis of the above working definition of sustainable investing, we looked at some of the definitional confusion in the category, some of the critiques of sustainable investing, and some of the efforts to create more definitional rigor. These we have separated into the following four buckets:

1. Critics of sustainable investing often contend that, because there are no

generally accepted standards for what constitutes a sustainable investment or investment approach, and because companies may receive different ratings from different ESG ratings agencies, such ratings therefore lack definitional rigor and have no financial relevance. These critics also complain that this makes it difficult, if not impossible, for companies to know how to track or report on their sustainability efforts.

2. Critics also scoff that sustainability ratings are "nonfinancial," incorporating subjective information that has nothing to do with financial performance. The result, they claim, is that certain companies or whole industries or sectors are excluded, and this runs counter to modern portfolio theory, which states that full diversification is necessary to achieve the highest possible returns.
3. ESG often is criticized as being mere window dressing or marketing hype, because some ESG funds invest in companies that everyone "knows" are bad.
4. Well-intentioned attempts to create sustainability ratings for funds have perhaps unwittingly added to some of the confusion in the marketplace.

Let's take these one by one.

'There are too many sustainability ratings, and they don't agree, so it is not an investable concept.'

As the body of research supporting the materiality of sustainability factors to financial performance has grown, so has the narrative that, "Well, if all sustainability ratings don't agree, then we can't use them at all." According to one article, inconsistent ratings create a reporting burden for companies.[3] Another report echoes this theme, noting that, as companies adjust their reporting to get better ratings, inconsistency in ratings thus increases the difficulty of reporting.[4] A third article posits that inconsistent ratings across ratings agencies impedes market efficiency.[5]

In finance, we are accustomed to some analysts rating a company as a "buy" while others rate it a "sell" or "hold" or some other category. This has not paralyzed markets: We recognize that the question of what makes a good or poor investment is a big question with a lot of dimensions, and that not everybody agrees on those dimensions or how to use them to make accurate predictions of future value. Dispersion in analyst ratings is so familiar that it often goes unremarked: Financial professionals know that analysts have differing opinions and methodologies, as well as biases.[6] In short, it is completely understandable, in finance, at least, that there would be multiple reasonable approaches to answering thorny questions such as what makes a company a good investment.

So why is that same premise considered such a handicap when it comes to sustainable investing? "What makes a company sustainable?" is assuredly as big and complex a question as "What makes a company a good investment?" It is common for any company to have strengths as well as weaknesses when it comes to sustainability, just as nearly every financial analysis finds strengths and weaknesses on every balance sheet and income statement.

We would go further. The suggestion that there should be one definition or one standard or one rating for what constitutes a sustainable company is on its face absurd. Is there one definition of what constitutes a value stock or a value fund? Might there be some disagreement between Benjamin Graham, Warren Buffett, and Joel Greenblatt, or the portfolio manager of Value Fund A and the portfolio manager of Value Fund B, about whether a particular company is an attractive value stock? Are they not allowed to, and, indeed, don't we expect them to have slightly different perspectives, placing slightly different weights on different factors to determine whether a company is a strong value stock that should be invested in? That doesn't mean the process is subjective; it means only that different approaches to analyzing the same largely objective data leads to differing conclusions. If there were no disagreement, if value stocks were not rated differently by different analysts, then all companies would get the same rating and all value funds would own the same securities.

The same is true of sustainable investing. Different ratings agencies or analysts or portfolio managers may have slightly different definitions of or perspectives about what constitutes a sustainable company, or they may weight certain ESG factors differently or have different views about which ESG factors are most material for a given sector or industry, or for a given company, at a given time, and therefore reach different conclusions about the sustainability profile of a given stock. Again, if they didn't disagree then all companies would have the same ESG ratings and all ESG funds would own the same securities.

Another common but misguided thread in the "too many ratings" narrative confuses ratings intended for investor use—ratings based on documented, defined, and tested methods of analysis and a great deal of factual and quantitative data—with lists such as the annual "best companies for X" or "the 100 most sustainable companies in the world" that are generated by media outlets, interest groups, and others.

For example, one recent paper complained that there are more than 600 ratings products from more than 150 organizations providing sustainability ratings.[7] For those of us in the business, this comes as a distinct surprise, because we're accustomed to having a small handful of sustainability ratings services to choose from. And we're not wrong.

To count more than 150 ratings organizations, the paper includes *Newsweek*, *Fortune*, and other media outlets that compile annual "top" lists. It's true that those magazines and others publish sustainability ratings of corporations, but if we import that concept into mainstream finance, it means that we'd have to include *Money Magazine* and *Inc. Magazine* and dozens of other business and news media among financial raters. But nobody in finance takes these ratings very seriously or confuses them with buy- or sell-side ratings from qualified analysts, just as we in sustainable investing don't see lists of the greenest or most sustainable companies as being worthy of consideration as actual investment guidance.

In reality, there are a handful of providers of rigorous, in-depth sustainability assessments for investors, including MSCI, Vigeo Eiris, Sustainalytics, and ThomsonReuters. Although their ratings don't always agree, that is not a problem; as we mentioned above, the same is true of financial ratings.

'If I incorporate nonfinancial information, my fund can't possibly perform well.'

It is common to see arguments that sustainability criteria are "non-financial" or "non-investment related." Thus, it is argued, funds that incorporate such criteria should expect some underperformance relative to the overall market. But the majority of actively managed funds, regardless of discipline, underperform their benchmarks most of the time. A recent article from the American Enterprise Institute showed that over a 15-year period, between 90 and 95 percent of U.S. equity funds underperformed their benchmarks;[8] and the *Financial Times* reported in 2016 that 99 percent of U.S. active equity funds underperformed, as did 97 percent of emerging market funds.[9] Reasons for that underperformance are manifold .[10] The point, however, is that it's difficult for any active manager to beat the market and no harder for sustainable investors than any other type of investor.

More importantly, the notion that sustainable investing requires a sacrifice in financial returns has been thoroughly debunked by a substantial body of research. Morgan Stanley, for instance, notes that this criticism is a myth and cites research showing that sustainable investing has "usually met, and often exceeded the performance of traditional funds."[11] Bank of America Merrill Lynch reported in 2016 that "ESG could have helped investors avoid 90 percent of bankruptcies."[12]

Sustainable investing is a big, diverse discipline. Some funds do integrate a wide variety of sustainability criteria. Others may have a single theme, such as fossil fuel-free investing or avoidance of weapons or tobacco products or investing in companies with more women in leadership.

These studies are the tip of the iceberg. We've been collecting research that examines the relationship between sustainability and financial performance since 2000 and have a library of 550 studies that show sustainability and sustainable investing are not destroyers of value but, to the contrary, are more likely to add to value than diminish it.

The growing body of research underscoring the materiality of ESG factors helps explain why financial analysts increasingly use sustainability criteria in their evaluations. Seventy-three percent of respondents to the CFA Institute's 2017 ESG survey said that they take ESG issues into account, and of those, two-thirds do it to help manage investment risks.[13]

Asserting that sustainability is "non-financial" or "non-investment related" is not a sound foundation on which to build a critique of the discipline.

'How can this fund be sustainable when it owns bad companies?'

People generalize all the time using incomplete evidence and may be particularly prone to do so when it's something that supports an existing bias. This can lead to, "See, I told you!" arguments based on a thin reed of evidence.

A recent example of this appears in a *Bloomberg Businessweek* article with the revealing title, "How Socially Responsible Investing Lost Its Soul."[14] The article asserts that as asset managers have embraced sustainable investing, their standards have fallen: "Criteria are so broad and disparate that companies as unlikely as ExxonMobil Corp. and Philip Morris International Inc., the maker of Marlboro cigarettes, make the cut in some cases."

The article does not specify how many times such companies make the cut, but it names only one fund as an example. In this article, apparently finding one or "some" is enough to condemn the whole discipline. In the United States, as of the latest trends report from The Forum for Sustainable and Responsible Investment, there were 780 ESG funds in 2018.[15] Is evidence that 0.13 percent of that universe of funds holds ExxonMobil proof that the entire group has "lost its soul"? If not, what percentage would suffice to constitute prima facie evidence of soullessness?

Sustainable investing is a big, diverse discipline. Some funds do integrate a wide variety of sustainability criteria. Others may have a single theme, such as fossil fuel-free investing or avoidance of weapons or tobacco products or investing in companies with more women in leadership. The stocks found in a particular ESG portfolio will be a function of the portfolio strategy and approach. Moreover, it's worth noting that not all sustainable investment funds rely on exclusions; a fund may choose to register its sentiment about a company's sustainability profile by underweighting or overweighting it in a factor-based portfolio; or a fund may take a best-of-class approach that ranks companies within sectors and tries to invest in leaders while avoiding laggards. There are many different approaches one can take in constructing a sustainable investment portfolio.

It is true some sustainable funds that do follow a best-in-class approach may include some names from industries that generally are seen as incompatible with sustainability, such as tobacco or oil. Over the nearly five decades that we've practiced sustainable investing, we have almost never observed an industry where there wasn't a substantive distance between the best companies in the industry and the laggards. Investing in the best in the sector can transmit the message to companies that more sustainable operations are preferable to investors, and that may have more power than simply divesting, which gives companies no information at all. Although it might therefore be surprising—and we would think, unusual—to find a name like ExxonMobil or Philip Morris in a fund with a sustainability overlay, it's worthwhile to check the fund's criteria before deciding that the inclusion of a particular company in a particular portfolio is evidence of moral drift across the entire industry.[16]

Portfolios holding companies that don't seem to fit the discipline happens all the time in mainstream finance—so often, in fact, that it has a name—style drift. But you don't see critics claiming that, because they found a single value fund with a beta of 1.1, no utilities, an underweight to financials, and 10-percent weight in tech names, all value investing has thereby "lost its soul."

Sustainable investing is a sufficiently diverse discipline to permit diverse views of sustainability, a focus on different issues, or weighting of different ESG factors differently. Articles that generalize about the entire discipline on the basis of one or two apparently incongruous examples contribute neither rigor nor clarity to the debate.

'Can I trust fund sustainability ratings?'

The most broadly used fund sustainability ratings to date were introduced in 2016 by Morningstar, based on Sustainalytics research.[17] Although the Morningstar ratings are well-researched and constructed, and continually improving, their initial iteration was a good example of how a well-intentioned ranking system can be potentially misleading.

The Morningstar/Sustainalytics ratings have to date rated mutual funds based on the sustainability profiles of their underlying holdings over a trailing one-year time period, with higher weights on more recent holdings.[18] Moreover, they provide funds with a sustainability rating based on the underlying holdings regardless of whether a fund has a process in place for integrating ESG research and analysis. As a result, funds could back into their ratings accidentally, which, in fact, happened. The top two funds on *Barron's* 2016 list of "The Top 200 Sustainable Mutual Funds," which was compiled using the Morningstar/Sustainalytics ratings, didn't even make the list in 2017 because their ESG ratings fell to "average" or "below average."[19] Neither fund had a process in place for integrating sustainability criteria into portfolio construction. So, just as they unintentionally backed into their ratings one year based on their underlying holdings, they unintentionally backed out the next year when their holdings changed.

In our view, if a fund doesn't have a process in place for integrating sustainability criteria or ESG analysis into portfolio construction, a snapshot of its holdings over a particular one-year time period may not be sufficient to gauge its sustainability profile. Morningstar now identifies those funds that integrate ESG with "intentionality," but intentionality does not yet factor into the sustainability rating itself and is simply treated as a sub-category of sustainable funds. In our view, it should be the other way around: Funds that happen onto sustainable holdings without a process in place should be the sub-category, with self-identified sustainable investing strategies as the primary category. That said, intentionality alone should not suffice in assessing the sustainability profile of a particular fund, because a fund's underlying holdings could indeed belie its claims to sustainability. This is where the Morningstar/Sustainalytics holdings-based approach constitutes a genuine contribution and advancement to the field. In our view, both intentionality and results are important.

Our colleagues at Morningstar have been responsive to some of the issues that have been raised about their ratings; a recent methodological change looking at holdings over a one-year period—as opposed to a snapshot in time—is one example. We believe a three-year period makes more sense, but this is still a step in the right direction. Perhaps more importantly, in its recent "Sustainable Funds U.S. Landscape Report," Morningstar indicated it has begun to classify sustainable funds into four categories—ESG Consideration, ESG Integration, Impact, and Sustainable Sector—all of which include a measure of intentionality, so further refinements to its sustainability ratings may be on the way.

Morningstar does not yet incorporate proxy voting, which we believe would be a very useful measure of both intentionality and outcomes, into its sustainability ratings. We understand that Morningstar may be collecting proxy voting data, however, so it eventually may find its way into its sustainability ratings. In any event, it's not just about Morningstar; a newly launched ranking of gender-lens investment funds from As You Sow similarly fails to include proxy voting. In fact, almost all the fund rankings we are familiar with—with the lone exception of the "heart ratings" from Natural

Investments—fail to include any measure of how funds vote on proxies with regard to sustainability issues. We believe they should.

GOING FORWARD

We strongly favor the search for clearer standards and more definitional rigor in the field of sustainable investing, although we don't think it will result in unanimity regarding the ESG ranking of a particular company or fund. ESG analysts will still bring different perspectives to and draw different conclusions from the same data. Again, that's fine—it's the way markets are supposed to work. But the field needs more-uniform reporting of data so the market has the information it needs to sort ESG leaders from laggards and so investors can make informed decisions using all material information.

Before the Great Depression, investors didn't have financial data and were investing based on unsubstantiated statements from company management, rumors, or simple faith. After 1929, the United States enacted securities laws to provide an infrastructure of financial information for investors according to well-documented standards such as the U.S. Generally Accepted Accounting Principles.

We need to design a similar infrastructure of data and facts for sustainability. At present, there is very little in the way of required reporting by companies about their impact on air, water, soil, and climate, or the demographics and treatment of their workers at all levels, or their impact on communities of place and interest. Many companies do make such reports because of stakeholder demand, but the reporting is neither universal nor standardized; even companies with major problems can turn themselves into seemingly model citizens with strategic omissions and good spin.

We need simple, comprehensive, standardized reporting on metrics of sustainability to go with the financial information we already have in order to make better-informed decisions and investments. Initiatives such as the Sustainability Accounting Standards Board (SASB), the Global Reporting Initiative (GRI), the International Integrated Reporting Framework (IIRF), and the Task Force on Climate-related Financial Disclosure (TCFD) are good places to start. But these are all voluntary, and although their use is growing, there are significant gaps in reporting, particularly among mid- and small-cap companies.

The era of voluntary reporting needs to end. Without some form of mandatory reporting, reporting gaps, particularly among smaller companies and in less-developed markets, will persist. Investors need to be able to compare companies with their peers on all relevant parameters.

This may be starting to happen. The International Organization of Securities Commissions (IOSCO) has released its new Statement on Disclosure of ESG Matters by Investors, noting that environmental, social, and governance factors are important for investors to know:[20]

> *IOSCO Principle 16 states that issuers should provide 'full, accurate, and timely disclosure of financial results, risk, and other information which is material to investors' decisions.' With regard to this Principle, IOSCO emphasizes that ESG matters, though sometimes characterized as non-financial, may have a material short-term and long-term impact on the business operations of the issuers as well as on risks and returns for investors and their investment and voting decisions.*

Most stock markets do not require ESG disclosure, but it seems clear that many are moving in that direction. The Sustainable Stock Exchanges Initiative notes that more than 30 exchanges around the world have made commitments to promote sustainability; thus far, 43 exchanges have published guidance on sustainability reporting. The European Union now requires ESG reporting from companies with more than 500 employees under Directive 2014/95/EU. This directive took effect in 2018 and requires companies to report on "policies, risks, and program outcomes related to environmental protection, social responsibility and treatment of employees; respect for human rights; anticorruption and bribery matters; and diversity on company boards, with respect to age, gender, education, and professional background." This is not comprehensive, but it is a good start.

Finally, for companies bemoaning that they don't know where to begin or are flummoxed by competing ESG ratings or standards, our advice is simply to get off the dime and start somewhere. A company might start with SASB's materiality map, which provides a list of material issues by industry.[21] GRI offers a menu of starter tools for first-time sustainability reporters on its website.[22] The IIRF offers a guide to integrating sustainability reporting with financial reporting.[23]

Companies are like human beings—none are perfect and no one expects them to be. But a company's many stakeholders expect it to strive for improvement, if not perfection. If a company believes it can simply do nothing, or change nothing, but look good from a sustainability or ESG perspective because there's a rating that might make it look good, then it is missing the point. Central to the core concept of sustainability, and the core focus of sustainable investing, is the notion that capital markets can produce better, more sustainable business practices and outcomes. The sustainability imperative, we hope, induces companies—indeed, pressures them—to change—to adopt better ESG policies and processes that contribute to better outcomes. Even a company with a favorable sustainability profile or rating eventually will fall behind if it stands in place while others improve.

Which returns us to the normative component of sustainable investing. We truly believe that corporations and markets can help to address the most urgent social and environmental challenges confronting the human community. The companies that take this responsibility seriously and fully integrate sustainability into their business models are more likely to prosper, as are their shareholders, employees, customers, communities, and the natural environment.

Investing in the transition to a more sustainable economy is not only financially competitive but compelling on its face. It is investing for the long term, and doing it well requires skill, forethought, and analysis. In short, it is not that different from what investing has always been about. It isn't something that can be reduced to a spreadsheet or that can simply be plugged into an existing investing process, which may be why so many myths and misconceptions about it still persist. Clear-headed examination of those myths and misconceptions is required, and more often than not we find that they wither under careful examination. Sustainable investing may require that we look at investing in new ways, and apply new tools and analyze new factors, but that's true of the march of progress in any discipline, investments included. Keeping up with the pace of change requires that we change. In our view, investors, clients, economies, and the planet itself will be better off if we do so. It is high time our investments pave the way to a more sustainable future.

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