BUILT TO LAST: THE MERITS OF ESG INVESTING

Exxon. Equifax. Enron. Financial markets are no stranger to scandal. Indeed, when it comes to investing, stories of corporate malfeasance are so common that they are often regarded as inevitable costs of doing business. Oil spills have happened at the hands of irresponsible ship captains and rig explosions. Companies have failed miserably on their promise to protect customers' personal information. Corporate executives and board members have acted recklessly in promoting their stock price, even when it required committing fraud. These events undoubtedly undermine our trust and confidence in financial markets and leave us feeling helpless.

Enter ESG, a deliberately broad term that refers to the consideration of environmental, social, and governance factors in selecting individual securities and building diversified portfolios. While the idea of ESG is not new, its application has evolved substantially in recent years. It began as a limited means of identifying and restricting investments in so-called "sin stocks," but has grown into a robust framework that seeks to align positive impacts on society with positive impacts on investment performance. Currently, variations of ESG are being applied to a variety of asset classes, including traditional stock and bond investment strategies, as well as alternatives such as hedge funds and private equity vehicles. By itself, ESG cannot cure all corporate ills, but it has undeniably charted a new path for effective investment analysis and risk management.

In this Insight, we will provide a detailed overview of ESG, its ubiquity in the investment landscape, and the catalysts that are driving its increased usage. We will also examine the empirical evidence on ESG's efficacy as a performance driver, while also exploring ESG's role in enhancing portfolio risk management. Finally, we will discuss exactly how ESG is already profoundly influencing client portfolios.

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Highland Associates, Inc. is an independent institutional investment advisor headquartered in Birmingham, Alabama. Highland was founded specifically to help develop, implement and maintain investment management programs for institutions. We serve a national client base of investors including not-for-profit healthcare organizations, foundations, endowments, defined benefit plans, defined contribution plans, and high-net worth individuals. As of March 31, 2018, we serve as investment consultant on approximately $23 billion in assets. Please visit the website at www.highlandassoc.com to learn more.

HIGHLAND ASSOCIATES
2545 HIGHLAND AVENUE SOUTH
SUITE 200
BIRMINGHAM, ALABAMA 35205
P. 1-800-405-7729 / (205) 933-8664
F. (205) 933-7688

Current Conditions And Catalysts

The Global Sustainable Investment Alliance (GSIA) is a recognized authority on the application of ESG practices in investment management. Through collaborations with its member organizations and global surveys of market participants, GSIA has gathered important data indicating why, how, and where ESG is being used to augment traditional security selection and portfolio management efforts. Specifically, GSIA has identified seven distinct investment strategies that use ESG in some shape or form, including 1) Negative/Exclusionary Screening, 2) Positive/Best-in-Class Screening, 3) Norms-Based Screening, 4) ESG Factor Integration, 5) Sustainability-Themed Investing, 6) Impact/Community Investing, and 7) Corporate Engagement/Shareholder Action. GSIA's formal definitions for each of these strategies are provided below.

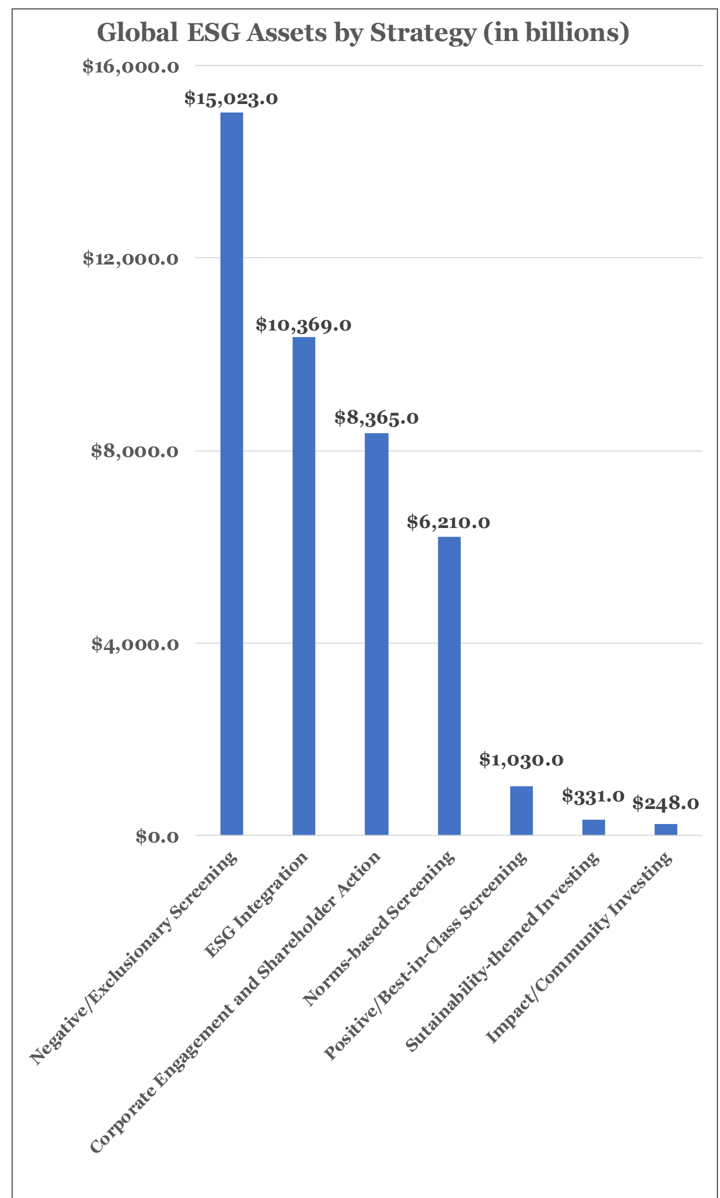
Figure 1

Strategy	Definition
Negative/Exclusionary Screening	The exclusion from a fund or portfolio of certain sectors, companies, or practices based on specific ESG criteria (e.g. tobacco, firearms, contraception, and/or pornography).
Positive/Best-in-Class Screening	Investment in sectors, companies, or projects selected for positive ESG performance relative to industry peers.
Norms-based Screening	Screening of investments based on compliance with international norms and standards (e.g. those issued by the Organization for Economic Cooperation and Development; the International Labour Organization; the United Nations; and UNICEF).
ESG Factor Integration	The systematic and explicit inclusion by investment managers of environmental, social, and governance factors into financial analysis.
Sustainability-themed Investing	Investment in themes or assets specifically related to sustainability (e.g. clean energy, green technology, or sustainable agriculture).
Impact/Community Investing	Targeted investments, typically made in private markets, aimed at solving social or environmental problems, and including community investing, where capital is specifically directed to traditionally underserved individuals or communities, as well as financing that is provided to businesses with a clear social or environmental purpose.
Corporate Engagement and Shareholder Action	The use of shareholder power to influence corporate behavior, including through direct corporate engagement (e.g. communicating with senior management and/or boards of companies), filing or co-filing shareholder proposals, and proxy voting that is guided by comprehensive ESG guidelines.

Source: Global Sustainable Investment Alliance; Highland Associates

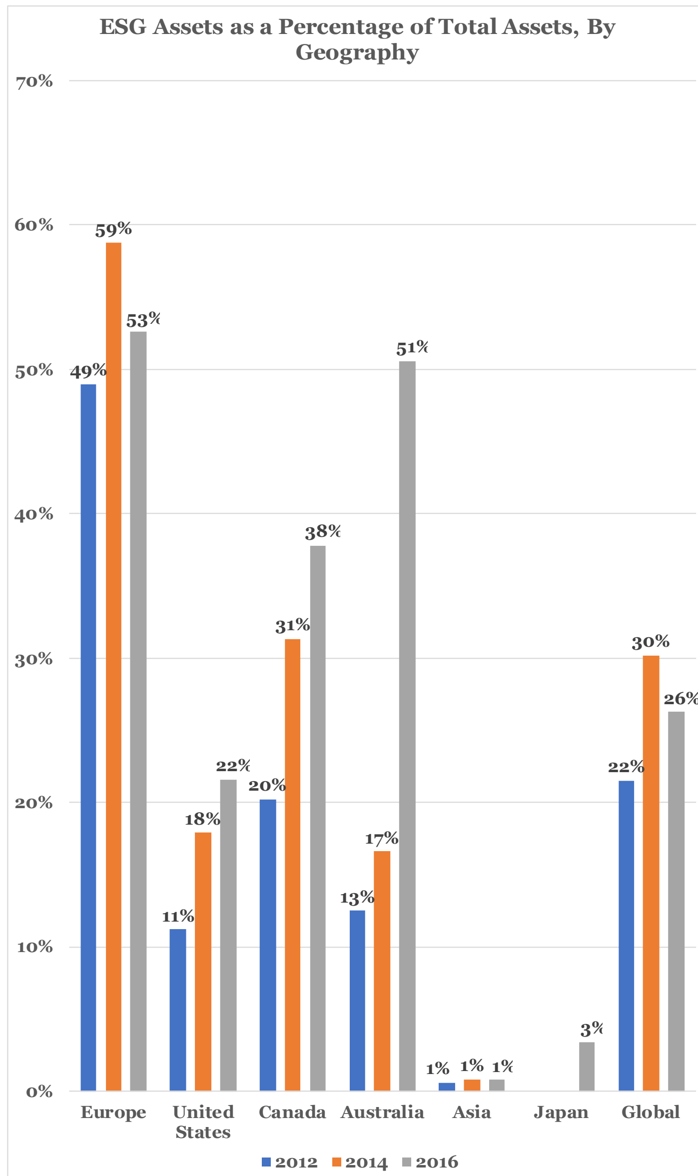
GSIA also tracks the amount of assets that are dedicated to ESG investing worldwide. Their most recent biennial report estimates that, as of 2016, nearly $23 trillion in global assets were managed under some form of ESG. This represents an increase of 25% from 2014. By region, Europe and the United States are the clear leaders in ESG adoption. GSIA estimates that 53% of professionally managed assets in Europe and 22% of professionally managed assets in the United States use some form of ESG. In particular, ESG assets in the U.S. grew 33% from 2014 to 2016 and now total $8.7 trillion, while European ESG assets grew 12% over the same period and now total more than $12 trillion. ESG assets have also grown materially in Canada, Japan, and other Asian markets in recent years. Figure 2 and Figure 3 illustrate ESG exposure by strategy and geography.

Figure 2



Source: Global Sustainable Investment Alliance; Highland Associates. (Note that since many investment strategies use multiple forms of ESG, the amount of assets credited to each use of ESG is larger than the total for all ESG.)

Figure 3



Source: Global Sustainable Investment Alliance; Highland Associates

A confluence of catalysts has driven continued ESG adoption and asset growth, including shifts in government policy, changes in investor preferences and demand, and responses from leading market service providers. Regarding government policy initiatives, globally coordinated responses to climate change have taken a major step forward. The United States, Europe, China, and Canada have pledged to reduce greenhouse gas emissions by anywhere from 25%-65% between now and 2030. This has created a new category of so-called green bonds, with hundreds of billions of dollars in issuances already. Collectively, trillions of dollars must be invested to meet these carbon reduction goals, and a substantial piece of required funding will come from the private sector. GSIA estimates that these and other initiatives have already driven more than $2 trillion in institutional investment assets related to climate change.

Increasing clarity around fiduciary duty has also paved the way for greater ESG adoption. In 2015, the U.S. Department of Labor issued guidance that private sector retirement plans would no longer be required to perform extra due diligence on "economically targeted investments," including those that emphasize environmental and social factors. The Department of Labor also issued guidance in 2016 that explicitly encouraged ERISA-plan fiduciaries to exercise their shareholder rights, where prior guidance had discouraged this. Outside of the U.S., select Canadian provinces have begun to require pension plans to report whether and how they integrate ESG factors into their investment policies, and there is a groundswell of support to make this disclosure a federal requirement. Japan has also taken significant steps to incentivize ESG considerations in investments. In 2014, the Stewardship Code was established to facilitate more engagement between institutional investors and their portfolio holdings. In 2015, the Corporate Governance Code created clear rules for whistle-blowers and general stakeholders' rights. Finally, the Japanese Government Pension Investment Fund (GPIF)—the largest pension fund in the world, with roughly $1.5 trillion in assets—has made great strides in promoting ESG adoption. In 2015, the GPIF became a United Nations Principles for Responsible Investing signatory and has since begun requiring that each of its asset managers directly integrate ESG into their investment processes. The GPIF has also invested nearly $10 billion in strategies that track ESG indices.

Changing preferences and behaviors among retail investors, institutional investors, and professional money managers are also driving heightened ESG awareness and adoption. According to one GSIA survey, 85% of professional money managers cited client demand as the top reason for incorporating ESG analysis into their investment decision-making process. In fact, retail investors represent a very significant piece of ESG-related investments, as GSIA estimates that the retail share of combined ESG assets in Europe, Canada, and the United States doubled from 13% in 2014 to 26% in 2016. In the U.S. alone, over one-third of all ESG assets are now retail. Changing demographics are partly responsible, as Millennials are far more likely to gravitate toward investments with some sort of social or environmental value. In fact, a recent U.S. Trust sur-

vey of high-net-worth investors in the U.S. found that nearly two-thirds of Millennials use social impact investment strategies in their broader portfolio. The same survey found that 75% of high-net-worth Millennials and 63% of high-net-worth women indicated that social and environmental impact strategies are important aspects of their investment decision-making. More broadly, there is simply greater and growing concern among individuals regarding environmental, social, and governance factors. Investors specifically cite concerns with climate change as an important environmental factor driving ESG adoption, while human rights, workforce diversity, and general consumer protections continue to support the social emphasis of ESG. On the governance side, prominent areas of focus include board composition and independence, executive compensation, and shareholders' rights.

Stakeholders and service providers from all sides of the investment community have responded to these shifts in investors' priorities. Last year, FTSE Russell and S&P Dow Jones Indices announced that future additions to their indices would exclude all companies with low or no voting share classes. In so doing, these index providers are seeking to ensure that public shareholders will have a stronger voice in holding executive management and corporate boards accountable in the areas of compensation, diversity, and capital allocation. MSCI, a global leader in the provision of investment decision-making tools and analytics, has invested heavily in its ESG platform, which now includes more than 150 dedicated analysts who produce overall ESG ratings on thousands of securities. Similarly, Sustainalytics has grown rapidly since its inception 25 years ago and now counts over 250 analysts that provide comprehensive ESG data and commentary on thousands of companies. Bloomberg, a data tool for thousands of institutional investors, is also currently providing sustainability scores for equity and debt securities around the world. More broadly, Morningstar, a long-time leader in evaluating a broad range of stock and bond funds, has expanded its platform to offer sustainability ratings on thousands of mutual fund strategies.

Current Conditions And Catalysts

The concept of ESG investing is clearly a compelling story for many market participants. However, investment performance is still the primary focus for most investors. Thousands of academic studies have sought to answer whether various ESG styles and strategies can produce alpha, and thus far there is no clear consensus. The general argument against ESG as a positive performance driver relates to how weaker investor demand for poor ESG companies actually creates opportunities for outsized returns in the long run. Specifically, as poor ESG stocks generate minimal demand, their price multiples decline and set the stage for stronger gains in the future. At the same time, investors favoring strong ESG stocks will bid up their prices, effectively reducing their long-term return potential. This dynamic is supported by some empirical evidence that so-called "sin stocks" have higher expected returns than stocks that are generally similar otherwise.

Conversely, some studies have concluded that ESG investing positively impacts returns because of its emphasis on financial quality. These studies are generally focused on the governance aspect of ESG, with data indicating that companies with a greater emphasis on financial discipline—and thus ultimate shareholder returns—tend to outperform. Specifically, research suggests that companies with high profitability metrics, disciplined capital allocation policies, and minimal issuance of new equity often earn a premium relative to their peers. This makes intuitive sense, as such firms typically report stronger returns on investment. More broadly, these characteristics are generally associated with a longer-term orientation aimed at steadily promoting shareholder value instead of a short-termism that seeks to meet arbitrary quarterly earnings estimates.

Both arguments for and against ESG as an alpha driver have inherent flaws. Research shows that the higher expected return for poor ESG stocks might actually be explained by other related factors, including smaller size and cheaper valuations. At the same time, there is evidence that the performance premium attached to stronger corporate governance may be receding as investors become aware of this perceived market inefficiency. With limited data and a lack of standardized reporting practices for all dimensions of ESG (including environmental and social), many investors and academics agree that it would be premature to assume a statistically significant value add from ESG-focused strategies.

Despite the ambiguity of ESG's impact on returns, Highland still believes that ESG can offer substantial value for investors based on its contribution to risk management.

Despite the ambiguity of ESG's impact on returns, Highland still believes that ESG can offer substantial value for investors based on its contribution to risk management. ESG is distinguished as a risk management tool in many ways. Perhaps most importantly, investors who emphasize strong ESG practices are, by definition, more oriented to the future and the long term. The entire basis for ESG is sustainability, and investors who emphasize an understanding of ESG's increasingly prominent role in the evolving global economy should be rewarded with lower risk. By understanding their holdings' exposure to ESG factors, investors can differentiate between those companies that are clearly enhancing their ESG efforts and those that are not. As a result, investors who emphasize companies with stronger environmental protections, more customer-centric business models, and more shareholder-friendly governance practices will be more likely to avoid the scandals we've seen at Exxon, Equifax, Enron, and countless others.

Empirical evidence also supports ESG's efficacy in risk management. Investment management firm AQR, for example, has shown that companies with poor ESG ratings (bottom quintile) consistently carry higher total risk and higher stock-specific risk than those with strong ESG ratings (top quintile). Their research also found that the degree of difference in risk is substantial, as stocks with the worst ESG ratings exhibited roughly 15% higher volatility than stocks with the best ESG ratings. Unsurprisingly, AQR's research also shows that companies with better ESG ratings are characterized by superior quality characteristics, including lower earnings variability and higher levels of profitability. More broadly, research shows that ESG factors help to identify and quantify risks that are not easily captured by traditional risk measurements. For Highland, the key takeaway is that stronger ESG practices seem to be correlated with higher quality and lower risk. As our research evolves, this relationship between ESG and quality will be a primary emphasis.

ESG And Your Portfolio

ESG has materially influenced client portfolios for quite some time and will certainly continue to do so going forward. For some clients, negative/exclusionary screening remains the preferred choice for aligning organizational missions with investment outcomes. The overwhelming majority of Highland's approved managers are willing to customize client portfolios in a separate account structure to accommodate any required restrictions on individual securities or industries. In these situations, Highland is always careful to illustrate how proposed restrictions may incrementally alter the performance profile and the risk characteristics of the portfolio. Highland also supports our clients in helping to determine the materiality of certain ESG risks in their proposed restrictions.

At Highland, ESG's biggest influence occurs within the fundamental analysis of individual managers. We can confidently say that each of our approved traditional equity and bond managers rely to some extent—implicitly or explicitly—on examining ESG factors in their initial and ongoing fundamental due diligence efforts. Several of our approved equity and fixed income managers are United Nations Principles for Responsible Investing signatories, indicating their broad commitment to sustainable investing. More and more of our approved managers are treating ESG as an explicit consideration in their underwriting of potential investments. Our approved managers are increasingly taking the time to understand how executive management teams across industries are adopting their business models for sustainability. In this context, our managers are seeking to understand how precisely companies are planning to reduce environmental impacts, promote positive working environments and relationships, and properly align management compensation and decision-making with investors' best interests. A summary of key topics that our approved managers have identified as material issues in ESG evaluation is provided below.

Figure 4

Environmental	• Carbon emissions/climate change strategy • Water-related risks • Age of fleet/equipment • Recycling policy • Raw materials sourcing • Use of hazardous materials • Pollution and contamination controls • Waste management • Clean fuel standards and strategy
Social	• General corporate citizenship • Customer satisfaction • Human rights and corruption • Employee satisfaction • Healthy living • Workplace safety initiatives • Community partnerships/reputation
Governance	• Board composition/diversification • Executive compensation • Culture of innovation • Shareholders' rights • Capital allocation • Takeover defense mechanisms • IT/cybersecurity policy • Use of accounting accruals • Lobbying activities

Source: Highland Associates

Our approved managers differ in the manner in which they integrate ESG considerations into security selection and portfolio construction. Some approved managers focus more on the qualitative aspects of ESG, including the use of surveys and checklists to capture risks and opportunities related to ESG. Several approved managers specifically quantify these risks and opportunities in their financial models. Other approved managers assign ESG rankings or ratings for each potential investment, which are then used to inform stock-specific risk characteristics and required returns for each individual security.

Regardless of whether or how our approved managers use ESG, Highland is committed to quality in client portfolios. Roughly 75% of our approved and funded equity investment strategies report returns on equity in excess of their assigned benchmark by an average of over two percentage points.* ESG has certainly contributed to our quality emphasis, but it is not our singular focus. Beyond ESG, we carefully consider our approved managers' approaches to capital allocation, earnings variability, and management strength, among many other factors.

Highland continues discussions with managers that invest exclusively on the merits of ESG. Many of these managers have produced strong absolute and risk-adjusted returns, although mostly with limited track records. We will continue to underwrite these strategies as we do all individual investment strategies, with an emphasis on identifying 1) consistent investment teams, 2) differentiated and repeatable investment processes and philosophies, and 3) predictable performance patterns.

CONCLUSION

ESG investing is certainly not a new phenomenon, but it is rapidly evolving with changing preferences and policies among citizens, companies, and governments around the world. There are many ways for clients to use ESG to their financial advantage, while also promoting positive and sustainable effects on the environment and society at large. Highland feels investment managers' general consideration of ESG risks and opportunities is already influencing fundamental analysis, risk management insights, and overall portfolio construction. The benefits of this approach are tangible, including lower volatility and higher quality characteristics in portfolios. As ESG continues to evolve, so will Highland. We will continue to partner with our clients and the broader investment community to find the most efficient and effective ways to implement ESG.

** Based on Return on Equity (ROE) data provided as of 12/31/2017 by 1) all of Highland Associates' currently approved and funded equity managers held across client accounts, and 2) all corresponding equity benchmarks. More detailed information including a list of equity benchmarks is available upon request.*

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Author:

WILLIAM H. WYKLE,CFA

DIRECTOR

HIGHLAND ASSOCIATES

BIRMINGHAM: 2545 HIGHLAND AVENUE SOUTH
SUITE 200
BIRMINGHAM, ALABAMA 35205
P. 1-800-405-7729 / (205) 933-8664
F. (205) 933-7688

ST. LOUIS: 7733 FORSYTH BLVD., SUITE 1103
ST. LOUIS, MO 63105
P. (314) 296-6171