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The Right Way  
to Invest

## Charting a Course for Sustainable Investing

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When Oppenheimer Funds decided to increase our commitment to sustainable investing, we knew that we needed to first spend a lot of time listening. We embarked on a series of meetings and discussions with hundreds of our clients and prospects across the retail and institutional markets, both in the United States and internationally. We also reached out to our peer asset management firms. These conversations have provided us with considerable perspective and helped us crystallize what we as a firm, and our industry, will need to keep in mind as we address sustainable investing in the years ahead.

### **1. Recognize that the conceptual challenges will always persist.**

When it comes to investing with an environmental, social, and governance (ESG) perspective, governance is perhaps the one area that is easiest to embrace. That is not to say there isn't still some debate about what constitutes good governance, but for the most part investment professionals have a long history of, and established practices for, evaluating the governance of countries and companies. The issues are not as clear cut when it comes to environmental and social. These topics are also incredibly complex. Understanding environmental impact, as an example, often requires in-depth scientific and technological expertise.

While there have been considerable advances in recent years in the methods for compiling data on and evaluating these issues, that evolution will likely continue in the years ahead. That being said, we think it is important not to lose sight of the forest for the trees. That will mean not getting too caught up in the particulars—or the trees—of how data is compiled and evaluated on these matters. Staying focused on the forest will enable us to remember that we are continuously developing new and more advanced ways to evaluate the risks and investment opportunities associated with environmental, social, and governance issues.

### **2. While the rate of adoption varies for different types of clients and different regions, all clients and regions are showing increased interest in sustainable investing.**

There is no question that the institutional market is more aware of sustainable investing than the retail market, and that Europe, in particular, is well ahead of the United States

in the adoption of sustainable approaches. We believe that by 2020, asset managers will not be able to attract assets from European institutions unless they have a well-defined ESG approach, both at the firm and strategy level.

Even in this broad context, though, there are still some U.S. institutions that are further along on the integration of ESG principles than some of their European counterparts are. We may still be in the early stages in the United States, but there is a clear trend of increased adoption. The research and consulting firm Greenwich Associates found that 27% of institutional investors in North America employ ESG criteria when selecting managers, and 52% of them adopted an ESG approach in the past three years.

For the U.S. retail market, the research firm Cerulli Associates found that 18% of advisors use ESG investment strategies and 24% expect to increase the use of such strategies in the next 12 months. In the European retail market, socially responsible funds' share of retail assets under management increased from 2.4% to 24% over the past 10 years, and that could be a harbinger of what could happen in the U.S. market over the next decade.

### **3. ESG-oriented regulations will likely remain divergent.**

In Europe, ESG considerations are increasingly becoming part of the regulatory landscape. This year, the European Commission presented a package of proposals that would establish a unified classification system for what constitutes sustainable economic activities, improve disclosure requirements on how institutional investors incorporate ESG factors into their process, and create a new category of benchmarks for investors to compare companies' carbon footprints. These proposals could become law by 2020.

U.S. regulations are arguably moving in the opposite direction. There is no national policy on climate change or environmental issues. The U.S. Department of Labor issued cautionary guidance to ERISA-governed retirement plans about incorporating ESG considerations into investments, and the Securities and Exchange Commission is considering reshaping the proxy voting process in ways that could have uncertain implications for ESG-based initiatives and activism among shareholders.

While this divergence makes matters more complicated, it is true that most asset managers have global businesses. Having a clear ESG approach at the firm and strategy level will become a requirement for serving international clients.

### **4. “E” will likely become the most critical component of ESG over the next 5 to 10 years.**

The financial implications of climate change will likely take on increasing importance in ESG conversations. Across the globe, there are now four major climate change-related investment initiatives. First, Michael Bloomberg is serving as the Chair of the Financial Stability Board's Task Force on Climate-Related Financial Disclosures. The stated goal of the task force, which is also championed by Governor Mark Carney of the Bank of England, is to “develop voluntary, consistent climate-related financial risk disclosures

for use by companies in providing information to investors, lenders, insurers, and other stakeholders. Already, 390 investors with \$22 trillion in assets have signed on to support and implement this policy. The second major initiative is Climate Action+, in which 289 investors with \$30 trillion in assets are engaging with greenhouse gas emitters, looking for ways to encourage them to make a transition to clean energy. Third is the Portfolio Decarbonizing Coalition, in which 32 investors with combined assets of \$800 billion are looking to gradually decarbonize their portfolios. Finally, in July 2018, the world's seven largest sovereign wealth funds (SWF) published the One Planet SWF framework, a set of key investment methodologies and principles related to climate change issues.

**5. ESG data have become increasingly sophisticated, but may never adhere to a uniform standard.**

Many practitioners are offering sophisticated data for evaluating companies' ESG practices. But there is little correlation between the data they provide. Two of the biggest providers—MSCI and Sustainalytics—have only a 0.3 correlation in their stock level ratings. It is unlikely that their ratings systems will converge. That difference enables investors to select the firm whose methodologies align best with their own investment processes. In our view, the divergence is a feature, not a bug, of ESG ratings.

**6. ESG considerations are being integrated into the asset management business in many indirect ways.**

Beyond clients asking for ESG issues to be a consideration in how their money is managed, these principles are being incorporated into the asset management industry in a number of other ways. Major investment banks are increasingly incorporating ESG measures into both the qualitative and quantitative research they offer on companies. Credit rating agencies, such as Standard & Poor's, Moody's, and Fitch, are incorporating ESG issues into their ratings. Many private-sector companies themselves are doing more to reveal to investors how they address environmental issues, social inclusion, and transparent governance. As an example of this, 80% of the companies in the S&P 500 publish an Annual Sustainability Report. Six years ago, just 20% did.

These changes mean that ESG considerations will continue to become an ever-more important part of our financial system.

**7. Asset managers will have to integrate ESG considerations at the strategy and firm level.**

Asset managers will increasingly have to offer investment portfolios that take ESG considerations into account, and they will have to clearly articulate how those considerations are woven into their investment processes. But that will not be enough. Asset managers will also have to adopt ESG into their own business practices. Increasingly, investors will look for a strong commitment to sustainable approaches among a company's leaders on its board, in its C suite, and among its portfolio

management teams. As is often said on this topic, companies will not simply be able to talk the talk. They will also have to walk the walk.

We know that the issues related to sustainable investing will keep evolving. And our listening efforts will not be a one-time exercise. We will continuously engage with our clients and all these key audiences, as we search together to identify the best ways to deliver sustainable investments.

Mutual funds and exchange traded funds are subject to market risk and volatility. Shares may gain or lose value.

The stocks of companies with favorable ESG practices may underperform the stock market as a whole.

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