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The Right Way
to Invest

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Drivers and Detours on the Road to a Sustainable Future

The push for sustainability is a significant, durable global trend that has important implications for investors. At the same time, sustainable investing is a highly nuanced space lacking clear definitions or easy answers. There are many different ways that investors can engage with sustainability, each with its own implications and potential outcomes. The bottom line is that asset management firms with an eye toward the future are increasingly recognizing the trend, grappling with its complexities, and determining how and where to implement it in their portfolios.

No Passing Fad: The Push for Sustainability Continues to Grow

We define sustainability as economic and financial growth that is socially conscious and environmentally aware, supported by inclusive and transparent governance at all levels. Compared with the past, we're seeing a broad push for sustainability in our economy today, supported by four key growth areas, each of which is accelerating in size and scope. **Exhibit 1** ▼ This broad, growing support suggests a high likelihood that the demand for sustainability will only deepen in the years to come.

Sustainability: Economic and financial growth that is socially conscious and environmentally aware, supported by inclusive and transparent governance at all levels.

Exhibit 1: Four Drivers of Sustainability



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2040

The year by which the UK and France pledged to ban gasoline and diesel vehicles.

In public policy, we have seen an increase in sustainability policy commitments around the world:

- In 2015, all 195 governments of the world signed the Paris Climate Agreement, which seeks to reduce carbon emissions to near zero in the next 50 years, a possibility that has tremendous implications for financial markets and the allocation of capital globally.
- The UK and France have announced a plan to ban gasoline and diesel vehicles by 2040, and India has indicated that by 2030, all new vehicles sold in the country will be powered by electricity.
- Governments are taking steps to eliminate the pay gap. In Iceland, for example, businesses and government agencies must now demonstrate that men and women performing the same job receive equal pay, or they will face penalties, including fines.

85%

S&P 500 companies that shared sustainability data in 2017

In the business sector, we have seen major corporations and financial institutions make significant commitments to evolving their practices and investments for sustainability:

- More than 1,700 financial institutions (including OppenheimerFunds), representing more than \$70 trillion in assets, have signed the UN Principles for Responsible Investment, which support the development of a sustainable global financial system and provide a framework for incorporating ESG principles into the investment process.
- Google, the second largest company in the world by market capitalization, operated wholly from renewable energy for the first time in 2017.¹ It is also the world's largest corporate purchaser of renewable energy.¹ Other large companies are following suit.
- In 2017, 85% of companies in the S&P 500 Index published sustainability reports, up from 20% in 2011.²

-11%

Average annual reduction in the cost of a non-residential solar installation between 2000 and 2016.

In technology, the world has experienced major advancements over the past three decades that make all aspects of sustainability more possible:

- Rapid improvements in energy technology have powered the natural gas and renewable energy transitions. Solar energy, for example, has become more efficient and less expensive: Between 2000 and 2016, the cost of a solar installation dropped an average of 7% per year for residential and small non-residential systems, and as much as 11% per year for large non-residential systems.³
- The iPhone many of us carry in our pockets has more computing power than the computers that put the first man on the moon. Smartphones have powered a revolution in citizen engagement around transparency and accountability throughout society. This can be seen in the push by Information and Communication Technology (ICT) for transparent and inclusive budgeting processes in governments around the world, including in India, Brazil, South Africa, and the United States.
- We are seeing rapid advances in biotechnology that have the possibility of curing cancers and other major diseases, thereby improving the lives of hundreds of millions of people.

91%

Millennials who would switch brands to one associated with a cause.

In terms of changing social paradigms, there is a significant sustainability orientation among Millennials and women investors:

- A recent study by Nielsen found that 73% of Millennials are willing to spend more on a product if it comes from a sustainable brand.⁴
- 91% of Millennials report a willingness to switch brands to one associated with a cause, compared with a U.S. average of 85%. Among affluent Millennials, that number rises to 95%.⁵
- 63% of women consider social, political, or environmental impacts as "somewhat important" or "extremely important" when evaluating investments, compared with only 41% of men.⁶

These findings are all the more important given that, in 2015, Millennials became the largest segment of the U.S. workforce and are set to surpass Baby Boomers as the largest living adult generation in the United States.⁷ In the coming years, this generation will gain control over an estimated \$30 trillion that will pass from Baby Boomers to their children, which will further drive sustainable investing into the mainstream.

Potential Barriers in the Implementation of Sustainable Portfolios

There are many ways to incorporate sustainability in a portfolio, from niche strategies that target a specific issue, such as the environment, to strategies that incorporate ESG factors more broadly into the research process.

Despite the growing interest and assets under management in sustainable strategies, however, there are practical implementation challenges that prevent some investors and advisors from embracing ESG and impact investing in their portfolios. These nuances must be acknowledged, as they are integral to the conversation about the role of sustainable investing in the asset management industry today. Making progress will require finding ways to think about and engage with these issues.

1. What's in a Name?

The first stumbling block for sustainable investing is as basic as what to call it. Acronyms abound today—ESG, SRI, CSR, and RI, among others—that can make it hard for investors to understand and access this space. Discussions of sustainable investing (or ESG or SRI) generally refer to one of three categories of approaches:

- **Values-based investing:** These approaches exclude certain sectors, such as tobacco, coal, and firearms, to align a portfolio with an investor's values. Exclusionary strategies are where sustainable investing got its start, with divestment from South Africa in the 1980s to protest apartheid a prominent example of this approach. The current push toward fossil fuel divestment, which has drawn more than \$5 trillion away from the industry, also falls into this category.
- **ESG integration:** The bulk of sustainable investment strategies today use ESG integration approaches. Put simply, these are approaches that intentionally integrate environmental, social, and governance data considerations into investment and, importantly, proxy voting and shareholder engagement decisions. These approaches are not about exclusion—strategies can own any sector or company, as long as they consider the ESG aspects of the investment.
- **Impact investing:** Impact strategies allocate capital with a dual purpose of seeking financial returns and positive social and environmental outcomes. It is a relatively small part of the market and primarily comprises private and illiquid funds, but in the coming years, it is likely that more impact strategies will become available in the public markets.

Key Takeaways: When it comes to terminology, sustainable investing is in the eye of the beholder. Investment managers and intermediaries need to have a clear sense of what they—and their clients—mean by sustainable investing, because each of the three categories above implies different investment approaches, tools, and potential outcomes.

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2. Data, Data Everywhere

The last 10 years have seen a surge in environmental, social, and governance data disclosure from corporations. MSCI, a leader in ESG data, reports that as of 2017, 43% of MSCI ACWI Index constituents report sustainability data, up from 15% in 2014. **Exhibit 2** ▼

Exhibit 2: Disclosures Are Increasing, but Are Not Standardized or Comprehensive



Source: MSCI ESG Research—ESG Issuer Communications, as of 12/31/17.

While this growth is a welcome development, the ESG data available today lacks standardization in reporting and methodology. There are currently more than 115 ESG data providers, each with a unique methodology. Without a commonly agreed upon set of sustainability metrics for all companies, investors must wade through a hodgepodge of information to find what they seek.

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Key Takeaways: First, although ESG data is neither comprehensive nor standardized today, the space is evolving rapidly and will likely mature in the next decade. For now, investors need to adopt a proactive approach for engaging with ESG data, which includes testing and experimenting, to find a data set that is replicable and applicable to their approach.

Second, understanding materiality is essential. Certain data points are more important for some sectors than they are for others. Organizations like SASB (Sustainability Accounting Standards Board) are helping to define what is considered material for each sector. Depending on the company, investors may not need a complete data set to evaluate ESG considerations provided they have access to the material data.

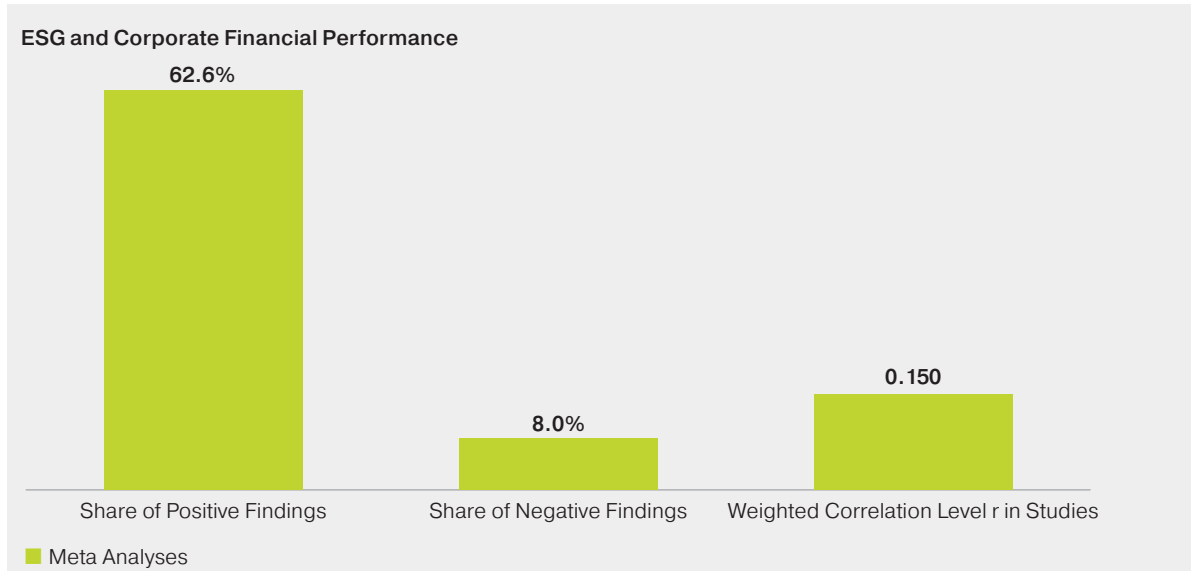
Finally, investors should recognize the value of both quantitative and qualitative ESG data. Some of the most valuable ESG data comes not from ESG data providers, but from personal research and engagement with a company on these issues.

3. Is the Proof in the Performance?

There is a longstanding debate about whether adopting a sustainable investing approach will cost an investor returns. Many in the industry remember the underperformance of some socially responsible funds in the 1990s and early 2000s that avoided some growth sectors and subsequently missed out on returns.

Recent empirical work, however, has demonstrated a clear, non-negative relationship between ESG performance and corporate financial performance. In a breakthrough 2015 study, researchers conducted a meta-analysis of more than 2,250 empirical studies that examined the relationship between ESG and various measures of corporate financial performance, including accounting-based performance, market-based performance, operational performance, growth metrics, and performance of ESG portfolios. The study concludes that over 90% of the underlying data points show either a positive or neutral relationship between ESG performance and corporate financial performance. **Exhibit 3** ▼

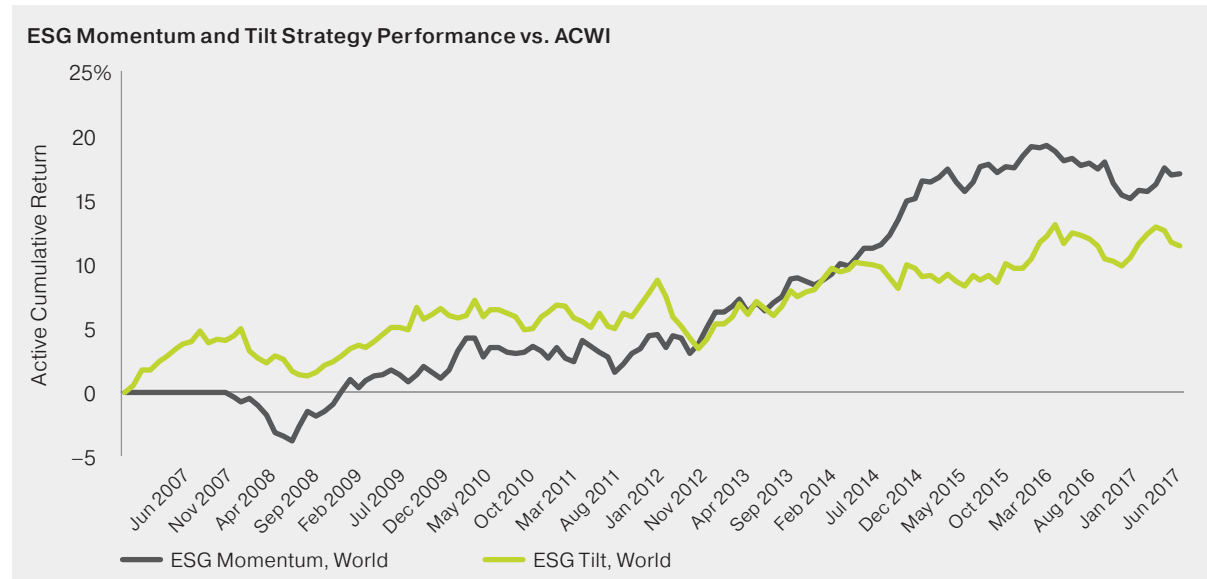
Exhibit 3: Studies Indicate a Positive or Neutral Relationship Between ESG Performance and Corporate Financial Performance



Source: Friede, Busch and Bassen, 2015.

Additionally, recent studies that draw on the increasingly comprehensive ESG data available today suggest that ESG integration can improve performance relative to the benchmark. A March 2018 study from UN PRI and MSCI shows that portfolios optimized around ESG momentum (i.e., an improvement in ESG scores) would have resulted in 18% of cumulative outperformance versus MSCI ACWI since 2007. A similar measure of ESG tilt (i.e., a best-in-class approach) would have led to 10% of cumulative outperformance versus MSCI ACWI since 2007. **Exhibit 4** ▼

Exhibit 4: Performance Potential of ESG Integration



Source: MSCI ESG Research—ESG Issuer Communications, as of 6/30/17.

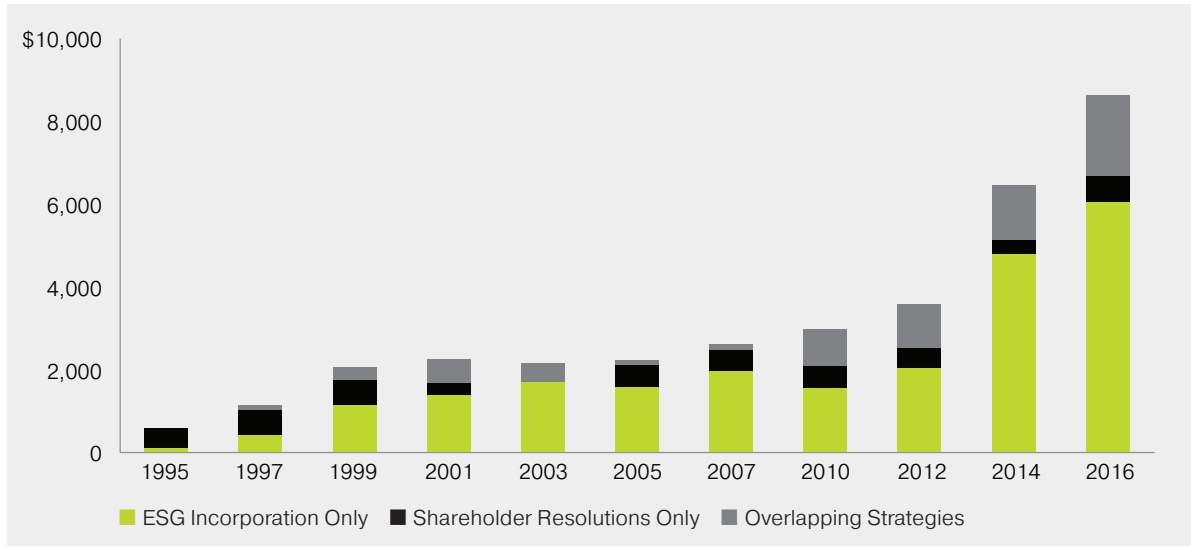
These recent studies largely focus on post-financial crisis market performance. Time will tell how the outcomes hold up over a full market cycle. These studies are examples of the type of rigorous analysis we can expect to see more of in the future now that the market has access to better, more methodologically sound ESG data.

Key Takeaways: The discussion about sustainable investing performance has moved beyond one centered on concerns about underperformance and toward one that acknowledges that an intentional focus on ESG can contribute to outperformance. As ESG data analysis continues to evolve, investors may ultimately find that not including ESG factors in the investment process will become a fiduciary challenge, as opposed to the other way around.

4. Room for Growth in the United States?

Roughly \$8.7 trillion—or 21% of all managed assets in the United States—has some element of ESG consideration as part of the process, an amount that tripled between 2012 and 2016. **Exhibit 5** ▼

Exhibit 5: Assets that Consider ESG Factors Are on the Rise



Source: US SIF, as of 12/31/16.

Key Takeaways: Institutional investors have largely driven the push for sustainable investing in the United States to date. In comparison with Europe, where more than 50% of all managed assets have a sustainable investing element, the United States has significant room for growth. The demand from retail investors is currently low, but interest from younger generations and a growing awareness among individual investors of the non-negative impact of ESG integration may contribute to growth over time.

Looking Ahead

Sustainable investing is a nuanced space that requires close analysis, but it is also evolving rapidly as the push for sustainability in the real economy gathers steam. As public policy, the business sector, technology, and younger generations continue to turn their attention to improving the world’s environmental, social, and governance issues, it will help fuel the growth of sustainable investment approaches. Should the United States begin to approach sustainable investing levels similar to what we see in Europe today, it would represent an extraordinary infusion of capital, both institutional and retail, into this space.



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Aniket Shah

Head of Sustainable Investing

Aniket Shah is Head of Sustainable Investing at OppenheimerFunds. He is responsible for building and integrating sustainable investment principles throughout the firm's operations. Before joining the firm in 2017, Aniket was the Program Leader of the Financing for Sustainable Development Initiative at the United Nations Sustainable Development Solutions Network. He is a graduate of Yale University and is completing his doctorate at the University of Oxford's Smith School of Enterprise and the Environment. He currently serves as the Chairman of the Board of Amnesty International USA.

Sharon French

Head of Beta Solutions

Sharon French leads the strategy, development and implementation of the firm's smart beta ETF products and solutions. In addition, she oversees the firm's Environmental, Social and Governance (ESG) efforts. She serves on the firm's Senior Leadership Team, governing the overall strategic direction of OppenheimerFunds. Sharon has held a variety of senior roles during her 30 years in financial services and joined OppenheimerFunds in 2016 from BNY Mellon, where she was Senior Strategic Advisor to the CEO and President of Investment Management, focusing on ETF and multi-asset business growth. Sharon serves on the Board of Women in ETFs. She received a B.S. in Business Management from the University of Delaware, and earned her Certified Investment Management Analyst® designation from the University of Pennsylvania's Wharton School of Business.

1. Source: Google Environmental Report, 2016.
2. Governance & Accountability Institute, Inc. 2018 Research—www.ga-institute.org
3. Lawrence Berkeley National Laboratory and the U.S. Department of Energy, Tracking the Sun 10, September 2017.
4. Nielsen, *The Sustainability Imperative*, October 2015.
5. Cone Communications, *2015 Millennial CSR Study*.
6. Pax World Investments, Women and Impact Investing, September 2015. https://fa.morganstanley.com/brent.gray/mediahandler/media/74524/Pax_Women%20and%20Sustainable%20Investing.pdf
7. Pew Research Center, Analysis of U.S. Census Bureau 1995-2015 Current Population Surveys.

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

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