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The Right Way  
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# Five Simple Principles of Sustainable Investing

## Executive Summary

- Sustainable investing is not new, but interest in it is on the rise. As more products and investment approaches become available, however, it has created confusion among investors.
- While performance concerns are cited as a reason investors are hesitant to embrace sustainable investing, research shows that incorporating ESG factors into the investment process can enhance risk-adjusted returns.
- These five principles of sustainable investing offer perspective to individuals and institutions about how to be an engaged, effective ESG investor.
- We believe that embracing a long-term perspective, considering non-traditional risk, understanding the new types of data and different investment approaches available today, and being an active owner are essential aspects of sustainable investing.

Interest in sustainable investing has grown dramatically in the last decade, as environmental, social, and governance (ESG) issues have gained prominence, and investors have come to recognize the materiality of ESG factors to financial performance. Shifting demographics are also playing a role, with younger and female investors seeking out opportunities to align their portfolios with their values.

But sustainable investing is not new. What started out decades—and even centuries—ago as a values-based, exclusionary approach has evolved to include a much broader array of strategies and investment vehicles. This evolution has, to a degree, mired sustainable investing in complexity, and today competing definitions conspire to confound rather than inspire investors. These five principles are an attempt to simplify some core tenets of sustainable investing. They are applicable to individuals and institutions, and offer perspective about how to be an engaged and effective ESG investor.

Before we dive into these core principles, however, let's set aside the performance debate. Sustainable investing has had a reputation for underperformance that dates back to a time when the most common approach was to exclude certain high-performing parts of the market, for example, tobacco stocks. Today that is no longer the case. The most prevalent sustainable investment approach, which considers ESG factors in the investment process, can actually help performance and, perhaps more importantly, reduce portfolio risk. This is common sense—having more information can lead to better investment decisions—but it is also supported by significant research. This is not to say that sustainable investment approaches always outperform, but they needn't be avoided by long-term investors seeking market-like returns.

## 1. Adopt a Long-Term Investment Mindset

Many investors, from large pensions with long-term funding liabilities to endowments to individuals saving for retirement, must of necessity adopt a relatively long time horizon.

There are potential benefits associated with a long investment horizon. These range from the straightforward—fewer transactions lowers investment costs—to the more theoretical: Adopting a longer horizon can help investors avoid chasing past performance (i.e., buying high and selling low). A report from the Thinking Ahead Institute at global professional services firm Willis Towers Watson estimates that there is a net long-term premium of 0.5% to 1.5% per year, depending on an investor's size and governance arrangements.<sup>1</sup>

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May Lose Value

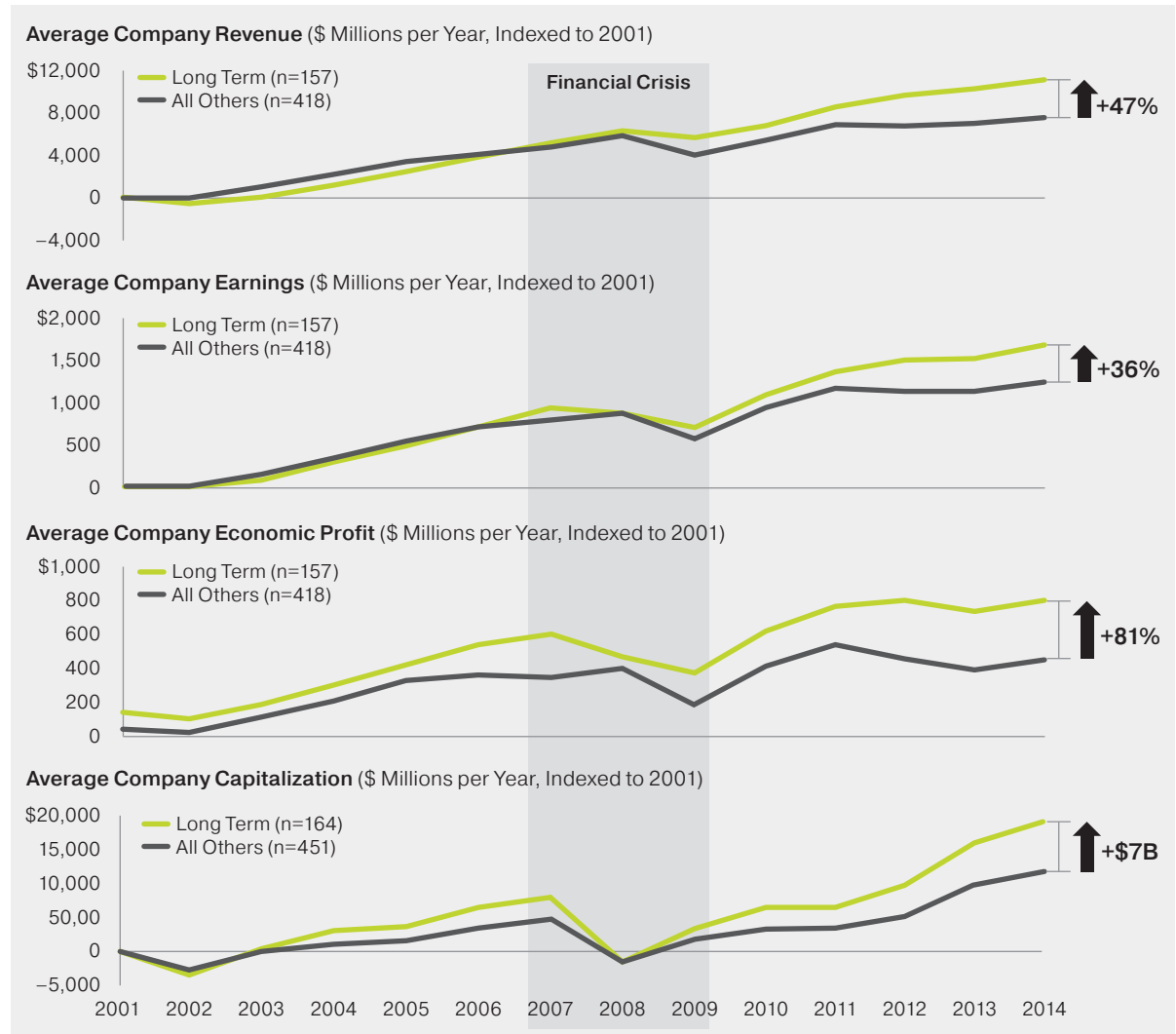
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What's more, companies that think long term may deliver better earnings and stock price performance. A study from McKinsey Global Institute examined patterns of investment, growth, earnings quality, and earnings management in companies between 2001 and 2014, and found that those identified as having a long-term mentality weathered the 2008 financial crisis better and outperformed their short-term counterparts. **Exhibit 1** ▼

**Exhibit 1: Long-Term Companies Exhibit Better Fundamentals and Performance**



Source: McKinsey Global Institute, Measuring the Impact of Short-Termism, February 2017. Note: Data include 615 non-financial firms with continuous revenue data from 2000 to 2015 (covering 60% to 65% of total U.S. public market capitalization over this period) and market capitalization of \$5 billion in at least one year during that period.

How does this relate to sustainable investing? At its simplest, sustainable investing is investing for the long term. Consider the issue of climate change. There are abundant reports of impacts we're seeing today, including shrinking glaciers, rising sea levels, and more intense weather events. But the effects will become far more pronounced in the coming decades, and this will create challenges and opportunities for companies.

For long-term investors, it's difficult to make the case today that environmental issues like climate change, as well as social issues like human rights and supply chain management ethics, will not impact their portfolio companies. How companies and other institutions respond to ESG-related challenges is likely to be an important contributor to their long-term performance and viability. Those that acknowledge the issues and adopt proactive strategies to mitigate ESG risks may ultimately deliver better long-term performance.

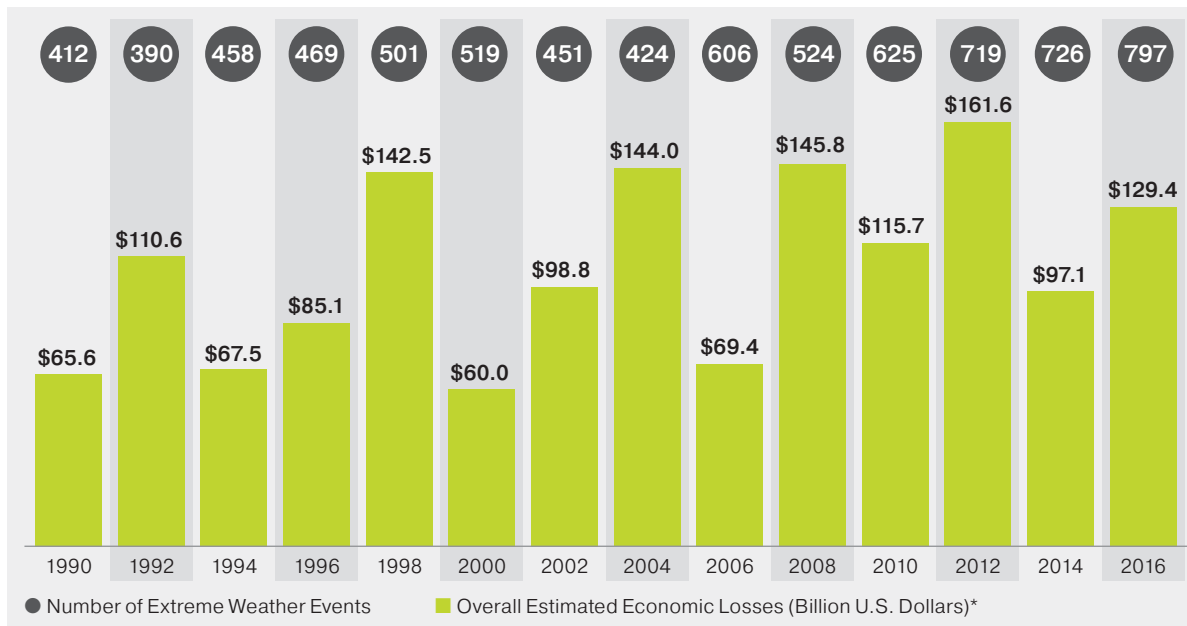
## 2. Understand Non-Traditional, Material Risks

As referenced in the introduction, incorporating ESG data into the investment process may enhance risk-adjusted returns because it provides a more comprehensive view into a company or issuer’s health than can be achieved through financial data alone.

The data contained in corporate balance sheet and income statements, for example, are integral to fundamental equity analysis, but for the most part, these reports don’t include intangible assets that may account for a significant percentage of a company’s value. A 2017 study by intellectual property advisory firm Ocean Tomo estimated that intangible assets accounted for 84% of the value of S&P 500 constituents in 2015, and that brand value represented, on average, one-quarter of that intangible value.<sup>2</sup> When a company’s brand health suffers because of a governance issue, for example, Volkswagen, after its 2015 emissions scandal—its earnings and share price may sustain lasting damage.

As the number of extreme weather events increases, the financial costs of climate change are growing, making it a critical risk factor for investors, companies, and governments. **Exhibit 2** ▼ A recent study commissioned by UN Climate, for example, looked at the relationship between climate vulnerability, sovereign credit profiles, and the cost of capital. The study found that climate vulnerability has already raised the average cost of capital in developing countries by 117 basis points. Over the next decade, additional interest payments attributable to climate change could cost these countries \$146 billion to \$168 billion.<sup>3</sup> Countries that invest in climate-related preparedness may succeed in reducing their risk exposure and improve their economic stability.

Exhibit 2: The Growing Cost of Climate Change



Source: The Lancet Countdown on Health and Climate Change, as of 12/16.  
 \* Adjusted to the 2016 values based on country CPI.

Another consideration is stranded asset risk. As the price of renewable energy falls and the world works to meet the Paris Agreement target (limiting the increase in the average global temperature to less than two degrees Celsius), reserves of carbon-based energy sources like coal, oil, and gas could become “unburnable,” or unable to deliver a return to their owners during their economic lifetime. Stranded assets pose a financial risk for fossil fuel companies and related industries, as well as their investors.

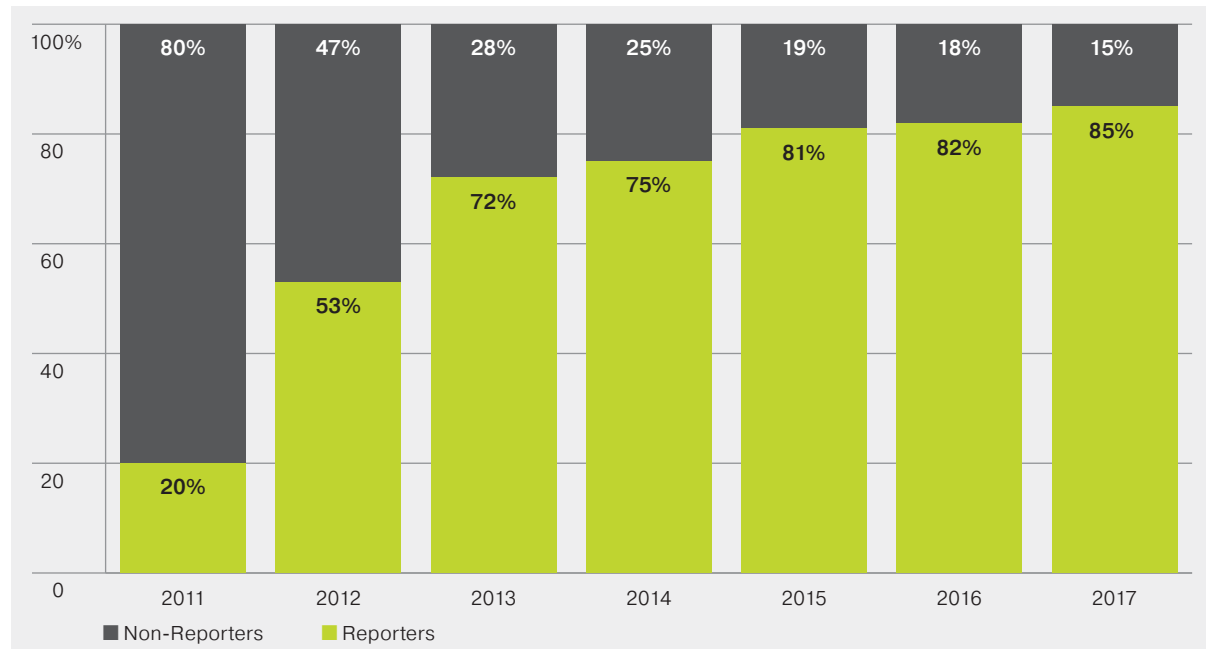
The bottom line is that considering ESG as part of the investment process offers investors another lens through which to view risk, and doing so may improve long-term, risk-adjusted returns.

### 3. Engage with New Types of Data

We're in the midst of a revolution that has improved both the quantity and the quality of the ESG data available. Companies are reporting on ESG issues more regularly, and firms like Sustainalytics and MSCI provide independent research and ratings that portfolio managers can incorporate into their fundamental analysis. **Exhibit 4** ▼ There are even companies like TruValue Labs that use artificial intelligence to deliver insights to investors on the ESG factors that can have a material impact on financial performance.

**Exhibit 4: More Companies Are Reporting on ESG Issues**

#### S&P 500 Companies



Source: Governance and Accountability Institute, as of 12/16.

On the fixed income side, corporate bonds enjoy similar coverage as equities, but data sets for municipal, sovereign, and agency bonds are still emerging. Evaluating the ESG characteristics of these issuers requires more effort to account for data deficiencies, but as stakeholders continue to apply pressure to municipalities, sovereigns, and agencies, regular disclosures of material ESG data will become more commonplace.

As ESG data becomes more mainstream and the volume of it grows, we are approaching a point at which investors may struggle to separate the signal from the noise. Sustainable investors need to adopt a systematic approach to evaluating these ESG-oriented data sets, understanding their methodologies, and determining their utility to the investment process through quantitative and qualitative testing. This means engaging with the traditional ESG data providers, such as MSCI, Sustainalytics, ISS, and Vigeo-Eiris, as well as the growing set of alternative data sets that measure non-traditional aspects of investments using satellite technology, artificial intelligence, consumer surveys, and other forms of data collection. The key takeaway is that the robust data available today—particularly on the equity side—offers investors a variety of ways to evaluate sustainability issues within a portfolio.

## 4. Choose from a Growing Set of Investment Tools

The issues at stake in ESG factors are complex and highly debated. We know, for example, that environmental destruction is happening, but haven't achieved consensus about how to fix it. The same is true about issues like reducing social inequality and identifying the right level of oversight within corporate governance.

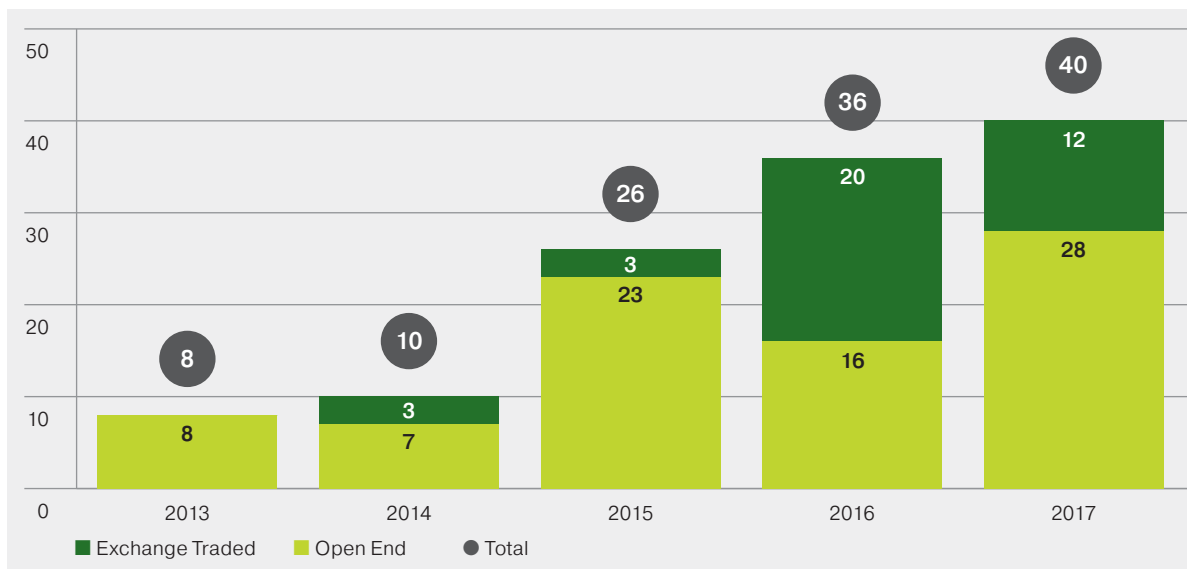
The inherent complexity of the ESG landscape doesn't lend itself to a common vernacular or a one-size-fits-all approach to sustainable investing, and the space has evolved to encompass a wide range of tools that investors can use to express their own viewpoints within a portfolio. The three most common approaches under the larger sustainable investing umbrella are:

- **Socially responsible investing:** Socially responsible investors can choose from vehicles including mutual funds and ETFs that exclude sectors, industries, companies, and categories of investments not aligned with their values. For example, MSCI has equity indices that exclude tobacco, controversial weapons, and coal and other fossil fuels. Indices, as well as actively managed funds, also exist for investors with a specific religious orientation (i.e., Islamic, Catholic Values).
- **ESG integration:** It has become common for investment managers to adopt a philosophy for integrating environmental, social, and governance data considerations into investment, proxy voting, and shareholder engagement decisions. ESG-integration investors have access to a wide range of products that explicitly and demonstrably integrate ESG considerations into the investment process. To help capital allocators determine whether an ESG integration approach meets their needs, companies such as Morningstar now evaluate the level of ESG integration of investment products using their Globes Ratings, which are available to a growing set of investors and financial advisors.
- **Impact and thematic investing:** Impact and thematic investors allocate capital with a dual purpose of seeking financial returns and positive social and environmental outcomes. Like SRI and ESG investors, they also have many options available to them today. Green bonds, which are issued by governments, agencies, and corporations to fund projects with specific environmental or climate benefits, are a good example of a thematic investment. There are dedicated investment vehicles for other themes, such as the OFI Pictet Global Environmental Opportunities Fund, which invests in companies that have a focus on products in the environmental solutions sector. In the private markets space, there are hundreds of impact-oriented investment funds that make investments in agricultural projects, education technologies, and other impact sectors. TPG's Rise Fund, which makes private investments in companies aligned to the UN's Sustainable Development Goals is one example.

Assets under management in strategies with a sustainable investment approach have grown more than 600% in the last decade, to \$23 trillion globally.<sup>4</sup> Launches of new ETFs and mutual funds with a sustainability focus are on the rise and run the gamut of geographies, as well as active and passive approaches. **Exhibit 3** ▼

Exhibit 3: Sustainable Fund Launch Trends

### New Funds Launched



Source: Morningstar Direct, as of 12/31/17.

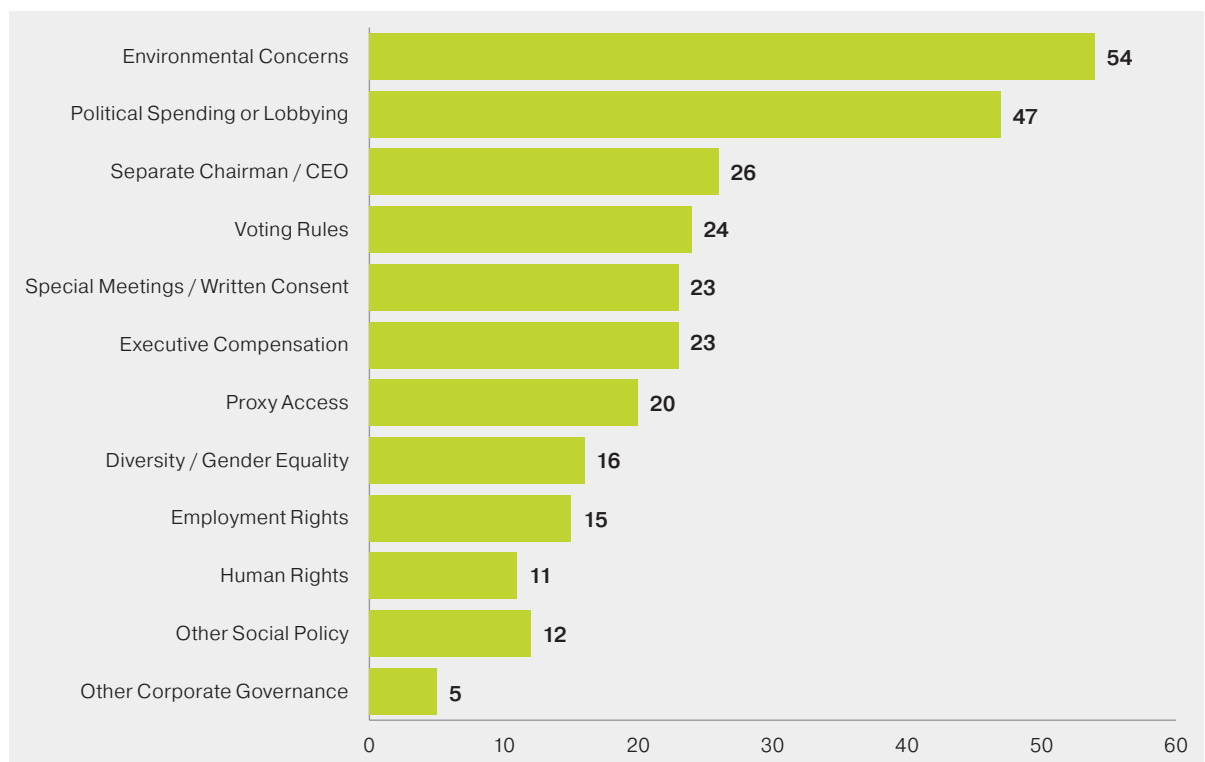
While the sheer number of strategies available today may appear overwhelming on the surface, they also make it easier for investors to find solutions that match the sustainability targets they've set for their portfolios.

## 5. Be an Active Owner to Enhance Long-Term Value

Should ESG investors own oil and gas companies or gun manufacturers? The early days of sustainable investing focused on divestment and socially responsible investing approaches that screened out industries and companies incompatible with investors' views. Today this is shifting to an emphasis on active ownership and driving positive change from within a company. In a sense, it's not what you own, it's how you own it.

Proposing and voting on shareholder resolutions is one way active owners engage with companies. Any shareholder that owns a minimum of \$2,000 in company stock for at least one year is eligible to submit a resolution that can be put to a vote at the company's annual meeting. Thanks to shareholder activists—primarily pensions and social policy investors—resolutions concerning sustainability issues such as executive compensation, the environment, diversity and gender equality, and human rights now make regular appearances on the proxy ballots. **Exhibit 5** ▼

**Exhibit 5: Shareholder Proposals by Subtype, 2017**



Source: ProxyMonitor.org database, as of 6/17. Includes 225 of the 250 largest publicly traded U.S. companies with annual meetings scheduled through the end of June 2017.

Between 2015 and 2017, environment-related resolutions accounted for more than half of ballot items at the 250 largest publicly held companies.<sup>5</sup> A small percentage of shareholder resolutions pass each year, but in 2017 there was a record number of favorable votes on these issues, according to Proxy Preview, a publication that tracks proxy voting matters. At the very least, shareholder resolutions are instrumental in drawing attention to sustainability issues at companies.

Institutional investors often keep their proxy voting rights or review the proxy voting policies of their portfolio managers. When individuals invest in a mutual fund, however, the fund manager typically votes the proxy. Few investors today are cognizant of how their fund company votes on ESG issues, either because they haven't thought to investigate them or don't know how to find the information. That's something that is likely to change as awareness increases about corporate sustainability and its potential impact on long-term performance.

Beyond proxy voting, institutional investors and asset managers are employing the significant leverage they have with investee companies to engage management teams in a dialogue about sustainability issues. Asset manager BlackRock, for example, issued a statement in 2017 that acknowledged the risks of climate change to the companies in which it invests, and outlined its approach to working with them on the ESG factors that may impact financial performance, as well as circumstances under which it would consider voting in favor of climate-related resolutions.

Other examples of institutional engagement with companies include State Street Global Advisors' board gender diversity initiative. In September 2018, the asset manager announced that, beginning in 2020, it would vote against entire slates of nominated board members at investee companies if the boards don't include at least one woman. Climate Action 100+ is a collaboration between global investors to help drive the low carbon transition through engagement with the world's 100 largest carbon emitters. On the fixed income side, institutional investors are engaging in similar ways with issuers to understand and evaluate their ESG-related exposures and initiatives.

An academic study of active ownership looked at engagements with public companies that addressed ESG concerns. It found that companies that score poorly on governance measures and have reputational concerns were more likely to experience successful engagements, and that these engagements were followed by positive share price performance.<sup>6</sup>

## Conclusion

Sustainable investing can be a challenging topic for investors to approach because of the complexity of the environmental, social, and governance issues at play and the bewildering and ever-expanding landscape of investment strategies, ESG data providers, and nomenclature. These are the "trees" of sustainable investing, and getting lost in them can prevent investors from missing the "forest"—the broad, system-wide, long-term efforts to respond to underlying ESG risks and opportunities. Keeping a big picture focus is essential to moving the financial system and the entities that operate within it toward a more sustainable future.

Read more about these issues and other sustainable investing topics at [OppenheimerFunds.com/sustainableinvesting](https://www.OppenheimerFunds.com/sustainableinvesting).



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**Arthur P. Steinmetz**

Chairman, CEO, and President

Art Steinmetz is Chairman, CEO, and President of OppenheimerFunds, Inc. Since joining the firm in 1986, Art has held a number of positions over his 30-year tenure, including Chief Investment Officer and Chief Investment Officer, Fixed Income. Art was named President in 2013, CEO in 2014, and in 2015, his role was further expanded to include Chairman.

Art is passionate about advancing financial and mathematical literacy, which he believes are essential elements of the next generation's success. He plays an active role in shaping OppenheimerFunds' philanthropic initiatives and serves on the Board of Trustees of the National Museum of Mathematics (MoMath) in New York City. In 2015, he was named "Man of the Year" by The YWCA of the City of New York for his efforts in promoting STEM education among girls and minorities.



**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 is the former Chairman of the Board of Amnesty International USA.

1. Source: Willis Towers Watson, The Search for a Long-Term Premium, June 2018. <https://www.willistowerswatson.com/en-US/insights/2018/06/gim-search-for-premium>
2. Source: Ocean Tomo, Intangible Asset Market Value Study, 2017 <http://www.oceantomo.com/intangible-asset-market-value-study/>
3. Source: Imperial College Business School and SOAS University of London, Climate Change and the Cost of Capital in Developing Countries, July 2018. [http://unepinquiry.org/wp-content/uploads/2018/07/Climate\\_Change\\_and\\_the\\_Cost\\_of\\_Capital\\_in\\_Developing\\_Countries.pdf](http://unepinquiry.org/wp-content/uploads/2018/07/Climate_Change_and_the_Cost_of_Capital_in_Developing_Countries.pdf)
4. Source: Morningstar, Sustainable Funds U.S. Landscape Report, January 2018.
5. Source: Proxy Monitor, as of June 2017. <http://www.proxymonitor.org/Forms/2017Finding1.aspx>
6. Source: Elroy Dimson; Oğuzhan Karakaş; Xi Li, "Active Ownership", The Review of Financial Studies, December 2015.

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