



Investing for Impact and Performance: The Essentials

- At Cornerstone Capital Group, we apply the discipline of **environmental, social and governance (ESG)** analysis along with **financial analysis** in assessing investment opportunities designed to help our clients achieve positive **impact** – the societal and environmental change resulting from investment decisions. This report lays the foundation for investors seeking to understand the core concepts of **investing for impact and performance**.
- **Increasing demand for impact-oriented investments** is being driven by a “perfect storm” of factors: Greater awareness of the importance of good governance in the wake of the crises and scandals of the past decade; increased transparency into corporate activity driven by technological advances; and the rising weight of intangible factors in the market valuation of investments.
- Experience and research have shown that incorporating ESG criteria into investment analysis yields **competitive financial returns**. Numerous strategies have evolved to help investors invest to achieve both impact and financial goals:
 - “Best in class” investing
 - ESG integration
 - Negative screening/divestment
 - Thematic investing
 - Community development and microfinance
 - Advocacy/engagement

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In November 2014 we published “ESG Essentials: A Guide for Investors.” The report served as a primer for those new to the concept, providing a basis for additional avenues of inquiry.

Much has changed in the three-plus years since we published that report. Interest in ESG-driven sustainable and impact investing has grown dramatically; a recent Bloomberg Intelligence analysis pegged growth in assets devoted to ESG investment strategies at 37% in 2017, topping \$445 billion globally. The range of investment options has expanded, and efforts to effectively measure the impact of ESG investment strategies are increasing.

We have updated our primer to reflect the evolution of ESG as an investment discipline. We’ve also altered the title to reflect the broader implications of investing to achieve certain societal outcomes along with competitive financial performance.

At Cornerstone Capital Group, we believe socially conscious investing is a truth, not a trend. We also believe it is a powerful, practical approach. We help our clients to align their investments with the issues that matter to them most, without sacrificing anything—except indifference.



Table of Contents

Executive summary	4
Introduction	5
The language of “impact”	6
Why invest for impact?	7
Values alignment.....	7
Societal impact	7
Financial performance.....	7
Universal ownership.....	8
Why is this trend becoming more mainstream now?	8
Impact themes emerging from long-term societal structural change	9
Technology increasing transparency.....	10
Increasing economic value of intangible assets	11
High-profile catastrophes.....	11
Key players	13
Investment value chain	13
Asset owners and beneficiaries.....	13
Asset managers	14
Corporations.....	14
Regulators.....	15
Professional forums and NGOs	16
Data providers, exchanges, rating agencies and indexes.....	17
Consultants and advisors	17
Investment strategies designed for impact	18
How does investing for impact affect financial returns?	19
Common misconceptions	21
Conclusion	24
Appendix: Summary of literature review	25



Executive summary

The language of impact. At Cornerstone Capital Group, we apply the discipline of **environmental, social and governance (ESG) analysis** along with **financial analysis** in assessing investment opportunities designed to help our clients achieve positive **impact** – the societal and environmental change resulting from investment decisions. Our overarching objective as a firm is **sustainability**, which we define as “the relentless pursuit of material progress towards a more regenerative and inclusive society.” *In this report we use ESG in discussing issues and investment strategies, and “impact-driven investing” when “investing for impact” would be cumbersome. We use “sustainable” or “sustainability” when referring to broad concepts.*

Why invest for impact? A growing number of investors wish to integrate their investing activities with the values that inform the rest of their lives or their organizational missions. They want to invest in ways that pay heed to both their financial priorities and their commitment to environmental or social issues. Some investors believe that doing so will grant them a financial edge in the marketplace. Others wish to influence the direction of the economy because they see their own futures as inexorably linked to the future health and prosperity of the world.

Why is this trend becoming more mainstream now? Increasing demand for impact-oriented investments is being driven by a “perfect storm” of factors. The global financial crisis of 2007-08, the Deepwater Horizon disaster and other events have made investors increasingly conscious of the systemic risks facing their portfolios. Beyond financial instability and the risk of industrial accidents, these risks include climate change, globalization, and inequality. Also, technology is driving greater transparency and accountability for companies, even as more of their value is tied to intangible factors that are becoming harder to measure through traditional financial analysis.

Key players. Today, the sustainability ecosystem includes some of the most sophisticated investment organizations in the market, as well as professional associations, data providers and others that can help investors invest for impact. With the help of a financial advisor who possesses the right expertise, investors can select the optimal mix of strategies designed to achieve both financial and impact objectives.

ESG-focused investing strategies and financial performance. Traditionally, the mainstream financial world has claimed that ESG-focused strategies would underperform their more traditional counterparts. However, experience and research have shown that these investments offer competitive returns. Recently, evidence has emerged that attention to ESG concerns may help both investors and companies mitigate risk and, in some cases, boost performance. Of course, investors may differ in the societal values that they bring to the market, just as they have differing risk tolerance and time horizons. Numerous strategies have evolved to help investors integrate their values into their investment portfolios. The best-known strategy, screening (positive or negative), remains important, but investors seeking social impact may also choose strategies such as active ownership, ESG integration or thematic investing.



Introduction

All investors make decisions in the context of some sort of value system, and all investments have impact.

All investments have impact

Furthermore, all investment has only two purposes, a private purpose and a social purpose. The private purpose is to build and preserve the wealth of the investor. Whether or not recognized by the investor, the social purpose is to allocate capital towards the most effective possible use for society. What the investor considers an “effective” use of capital has real world impact, because the priorities of investors have a powerful influence over which economic activities go forward and which do not. And very often, these priorities lead to productive activities that create jobs, useful products, and wealth for shareholders.

The problem comes when the private purpose overwhelms the social purpose. Many investors believe that the most effective use of capital maximizes return to the investor without regard to consequences for society. This approach to investing is often portrayed as rational and “values-free,” but experience shows that it is neither.

The financial crisis of 2007-08 began because of certain investments and business activities that were profitable, for a time. The consequences were disastrous both for society and for investment portfolios. The unfolding climate crisis tells a similar story. “Rational” choices about energy use threaten the natural world, the civilization founded in part on a stable climate, and investment results that depend on stable natural and human systems. A “values-free” approach to investing prioritizes choices that may be rewarding in the short term but self-defeating in the long term, both for the investor and for the society that depends on the effective and productive use of capital.

What sustainable and impact investments share is a priority to use capital resources to effect positive outcomes while adhering to, and even improving on, best investment practice for fiduciaries

The solution is not to abandon capitalism, which has improved the lives of literally billions of people, but to consciously embrace values that prioritize both the private accumulation of wealth and the use of capital for the common good. This kind of investing goes by many names — sustainable investing, impact investing, responsible investing and others — and comprises a variety of strategies and objectives. It encompasses all asset classes and risk tolerances. What sustainable and impact investments share is a priority to use capital resources to effect positive outcomes while adhering to, and even improving on, best investment practice for fiduciaries.

Cornerstone Capital Group helps our clients target their investments for competitive risk-adjusted returns based on their financial objectives and values, including environmental and social impact. We help clients find investments that meet their needs and provide asset allocation and reporting services that integrate our clients’ mission and values into their investment portfolios.



The language of “impact”

There are numerous labels used to describe investing activities that incorporate environmental, social and governance factors alongside financial metrics with the intention of achieving long-term financial outperformance as well as positive societal impact. Cornerstone Capital Group does not distinguish between “impact investing,” “ESG investing,” and “sustainable investing.” We believe these terms reflect the same motivations and strategies. Indeed, we consider this mindful method of investing to be “radically practical.” However, because these labels do mean different things to different people, we provide these clarifying definitions.

Impact is defined as the societal and ecosystem change resulting from investment decisions. Because these changes are the collective result of the actions of every investor, no one individual or institution controls these ultimate results; but each investor contributes to their achievement.

At Cornerstone Capital Group, our overarching impact objective is **sustainability**, which we define as “the relentless pursuit of material progress towards a more regenerative and inclusive society.” We believe that companies and investors with a long-term perspective on value creation will pursue strategies consistent with this idea of sustainability.

Environmental, social, and governance (ESG) practices describe the actions investors and companies take to achieve progress towards sustainability. Although environmental, social and governance are often bundled together, they are different. From a corporate perspective:

- **Governance** is the set of internal policies and management structures that establish the relationship among corporate stakeholders and define the objectives of the company. Governance policies establish mechanisms for oversight, incentives and culture that drive business operations and strategy.

- **Environmental and Social** policies refer specifically to the policies intended to manage a company’s impact on society as well as how it measures and reports on its engagement with these issues.

From an investor’s perspective, ESG is an analytical discipline – a framework for assessing the potential outcomes and impact of an investment.

In conducting our own ESG analysis, we focus on **materiality** – the ESG issues that are most relevant to both social and financial performance of a company or industry over the long term.



Why invest for impact?

Like any “traditional” investor, impact-driven investors seek financial returns. However, they are distinguished by their awareness of the broader context of financial sustainability. In this section, we outline a range of motives for investors to incorporate ESG considerations into their assessments.

Values alignment

The most basic rationale to invest for impact is to be consistent with personal values or organizational mission, and to avoid profiting from activities that violate core values.

Among the first investors who formally integrated values into their investments were religious societies in the 18th century who refused to invest in companies involved in the slave trade or other practices they considered sinful¹. As the variety of investment vehicles and the universe of investors have grown, so too has interest in addressing social issues through means other than policy and philanthropy. The financial services industry has, accordingly, developed a variety of methods for incorporating values into investments.

For instance, an asset owner concerned about income inequality has a range of options, as described in our 2017 report “[The Art of the Possible: Investing to Address Inequality](#).” Equity investors can advocate for corporate investment in labor forces, emphasizing training and creating career opportunities. Fixed-income investors can seek securities that fund health care, education, small business lending, affordable housing, or other social and environmental infrastructure.

Societal impact

When an investor places capital into a company, that investor is not only funding the company’s business strategy but also its labor, supply chain, diversity and environmental practices. By intentionally incorporating ESG criteria into capital allocation decisions, the investor helps to influence corporate behaviors toward those with positive (or relatively less negative) impact.

Investors also can invest directly in activities designed to achieve positive social or environmental impact. For example, investment in microfinance institutions places capital directly into the hands of individuals and organizations in low-income communities with the intent of improving income and opportunities. These investments may be offered at a market rate, though some investors may also choose to allocate a portion of their capital to below-market-rate opportunities to maximize social impact.

Financial performance

Some investors believe companies that maintain strong relationships with their stakeholders may more easily identify opportunities and manage risk over the long term. The discipline of

Investors are not only funding a company’s business strategy but also its labor, supply chain, diversity and environmental practices

¹ <https://russellinvestments.com/-/media/files/us/insights/institutions/non-profit/evolution-of-sustainable-responsible-investing.pdf>



ESG analysis, in the view of these investors, provides critical information about a company's potential for sustained long-term returns.

Traditional investment methodologies that emphasize current earnings have become less reliable

Recent academic research supports the thesis that a greater understanding of *intangible value*—such as the benefits provided by strong stakeholder relations—may provide useful information that is often overlooked by the market. A 2017 study by Feng Gu and Baruch Lev found that traditional investment methodologies are too focused on short-term earnings and may lack the ability to predict the value that businesses create. For businesses that invest resources into R&D, information systems, and brands, short-term earnings may not accurately signal long-term value. As a result, traditional investment methodologies that emphasize current earnings have become less reliable over the past 30 years².

This topic is further discussed below in the section “How does investing for impact affect financial returns?” and in a literature review in the Appendix.

Universal ownership

Universal owners are global investors (e.g., large pension and sovereign wealth funds) whose size means they have investment exposure to virtually every sector and region in the global economy. They are therefore more concerned with the sustainability and performance of the overall economy than with specific sectors or companies. Forced to evaluate portfolio-wide effects of individual firm actions, these institutions have increasingly found that incorporating ESG criteria into their investment decision-making facilitates better-performing markets, and therefore, better-performing investments.

In recent years, universal owners have increasingly leveraged their unique position to develop and pursue policies of positive environmental and social impact, and many now directly engage with corporations to influence their behaviors.

Why is this trend becoming more mainstream now?

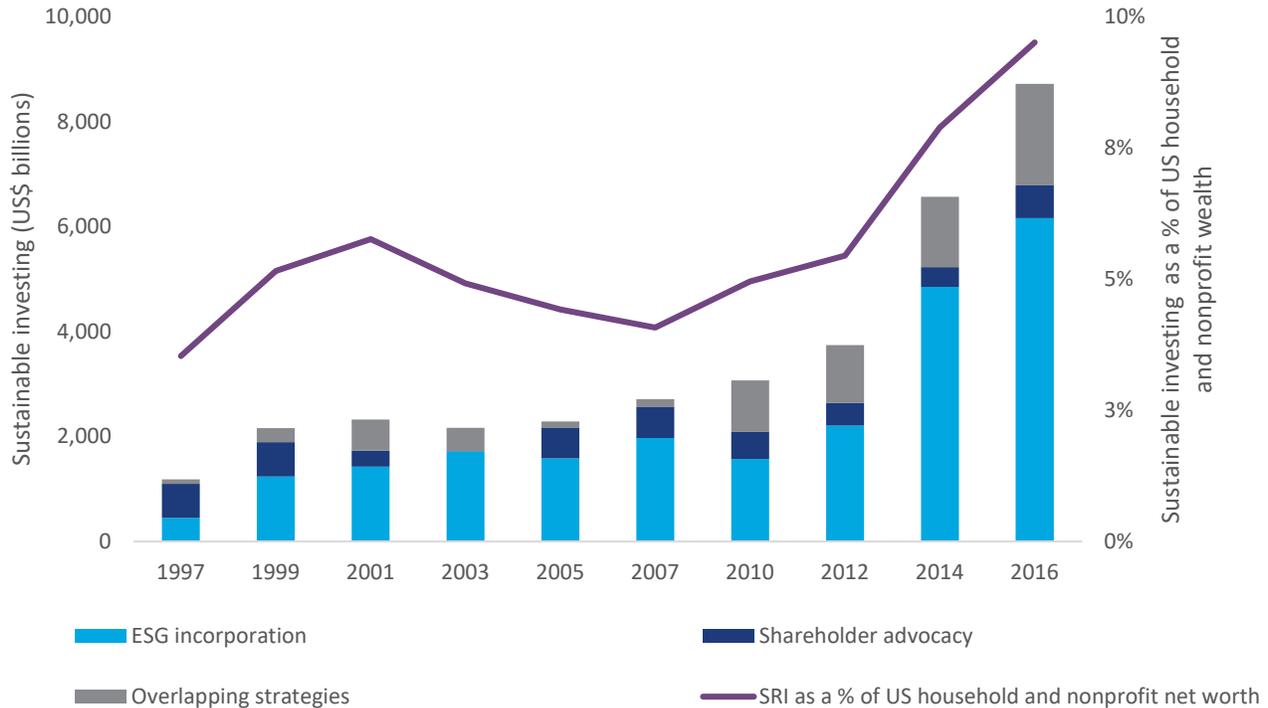
Assets managed for impact have grown significantly in recent years, as shown in Figure 1. A confluence of factors is intensifying the use of ESG criteria in investment analysis:

- Environmental and social factors emerging from long-term societal structural change;
- Technology pushing corporations to increase transparency;
- Company value drivers becoming harder to measure through traditional financial analysis; and
- High-profile events increasing the credibility of ESG analysis.

² <https://www.cfapubs.org/doi/abs/10.2469/faj.v73.n4.4>



Figure 1: ESG Assets Under Management



Source: USSIF, Federal Reserve, Cornerstone Capital Group

Impact themes emerging from long-term societal structural change

Climate change, inequality, globalization, and financial instability are structurally transforming societies, economies, and ways of doing business. For example:

- **Climate change:** The need for mitigation and adaptation to climate change is only growing, as the world approaches temperatures more than 2°C above pre-industrial levels. Key investment trends include clean power and infrastructure spending on transportation, energy and water efficiency.
- **Income inequality:** In addition to posing a serious risk to living standards (in the form of both declines and lack of advancement), income inequality may trigger political upheaval and undermine confidence in democratic institutions. Investors can address concerns about inequality responsibly by selecting managers who explicitly include analyses of diversity, hiring and employment policies in their evaluation of potential investments.
- **Globalization:** Increased access to foreign markets in recent decades has created economies of scale and broadened sourcing networks, benefiting both corporations and consumers. However, globalization has also contributed to wage stagnation for many middle-income workers in developed countries, which in turn has led to a growing distrust of institutions. While public policy is necessary to mitigate the negative effects of globalization, investors can still make a substantial impact through strategies ranging from corporate engagement to investing in community-focused fixed-income strategies.



■ **Financial instability:** Trade agreements and alliances and extra-territorial market institutions have expanded the reach of capital. An unintended consequence has been an increase in global financial systemic risk. We believe that ESG analysis enhances understanding of market and sectoral risks and can enable investors to position their capital to avoid such risks.

These four global issues serve as examples of how the ESG lens provides a unique perspective on structural changes to global society.

Technology increasing transparency

As technology drives information transparency, corporations face greater public scrutiny. This is particularly true as an increasing percentage of the world’s population is gaining internet access³. Investors can benefit as increased transparency provides higher-quality data and more opportunities to engage with companies.

Corporations’ ability to control public perceptions is diminishing

With numerous sources of information and channels of communications available, corporations’ ability to control public perceptions is diminishing. Indeed, damage to reputation and brand has emerged as a top risk from corporate managers’ perspective, according to insurance company Aon’s biannual Global Risk Management survey:

Figure 2: Top Risks as Identified by Corporations

	2011	2013	2015	2017
1.	Economic slowdown	Economic slowdown	Damage to reputation/brand	Damage to reputation/brand
2.	Regulatory changes	Regulatory changes	Economic slowdown	Economic slowdown
3.	Business interruption	Increasing competition	Regulatory changes	Increasing competition
4.	Increasing competition	Damage to reputation/brand	Increasing competition	Regulatory changes
5.	Commodity price risk	Failure to attract top talent	Failure to attract top talent	Cyber-crime/hacking

Source: Aon, Cornerstone Capital Group

This trend also highlights the growing importance to corporations of stakeholder engagement. As we outlined in our 2015 report “[The Networked Corporation](#),” companies are engaging with a wider variety of stakeholders as their value increasingly depends on these relationships. Many investors that integrate ESG into their strategies, particularly universal owners, engage with corporations and their stakeholders to assess the quality of corporate governance practices, which in turn indicates potential for financial sustainability, ultimately influencing valuations as a premium or a discount.

³ <http://www.gemalto.com/review/Pages/infographic-the-number-of-internet-users-by-2020.aspx>



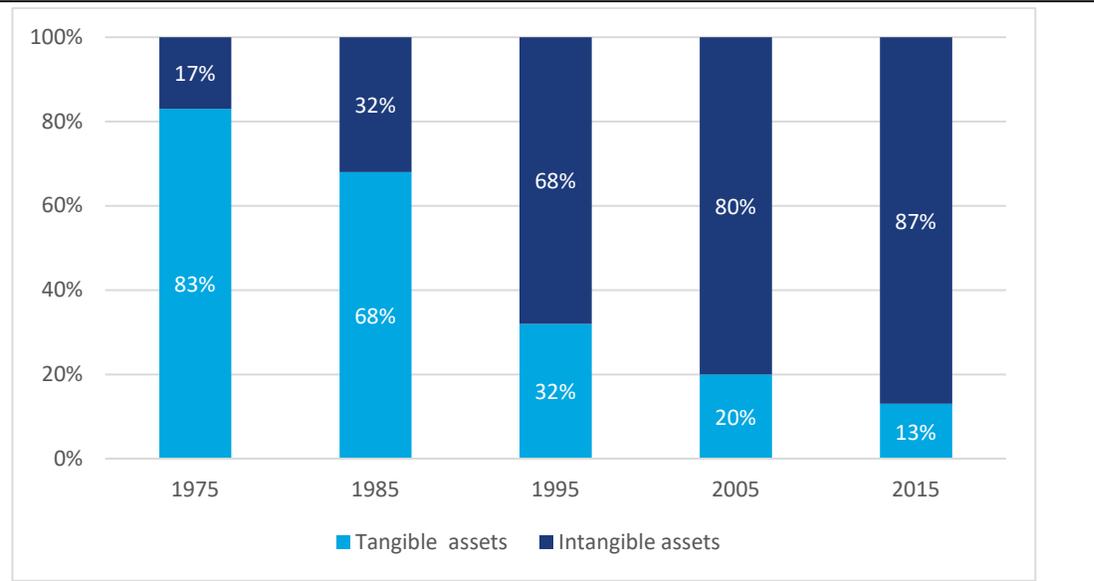
Increasing economic value of intangible assets

Many ESG strategies attempt to value assets that traditional investing has difficulty assessing

As discussed above, investment methodologies must adapt to changes in business models. Traditional investment strategies have seen decreasing returns over the past 30 years as businesses invest more in intangible assets⁴. Many ESG strategies attempt to value assets that traditional investing has difficulty assessing.

Intangible assets include intellectual property, such as patents and business models, as well as “goodwill,” roughly translated as the estimated value of a corporation’s brand⁵. According to research from Ocean Tomo, between 1975 and 2010, intangible assets increased from 17% of US S&P 500 companies’ market value to 87%⁶.

Figure 3: Components of S&P 500 market value



Source: Ocean Tomo, Cornerstone Capital Group

However, the shift in investor emphasis from tangible assets to intangible assets introduces more variability and uncertainty into the assessment of overall value. Investors must make assumptions about the future earnings contributions of intangible assets, but traditional market analysis struggles to value intangibles. A thoughtful and consistent ESG framework can include financial data on tangible assets as well as evaluate intangible assets as an indicator of company “quality.”

High-profile catastrophes

Certain high-profile events in recent years have increased investors’ interest in incorporating ESG assessments alongside traditional financial assessments.

⁴ <https://www.cfapubs.org/doi/abs/10.2469/faj.v73.n4.4>

⁵ <http://www.investopedia.com/terms/i/intangibleasset.asp>

⁶ <http://www.oceantomo.com/2015/03/04/2015-intangible-asset-market-value-study/>

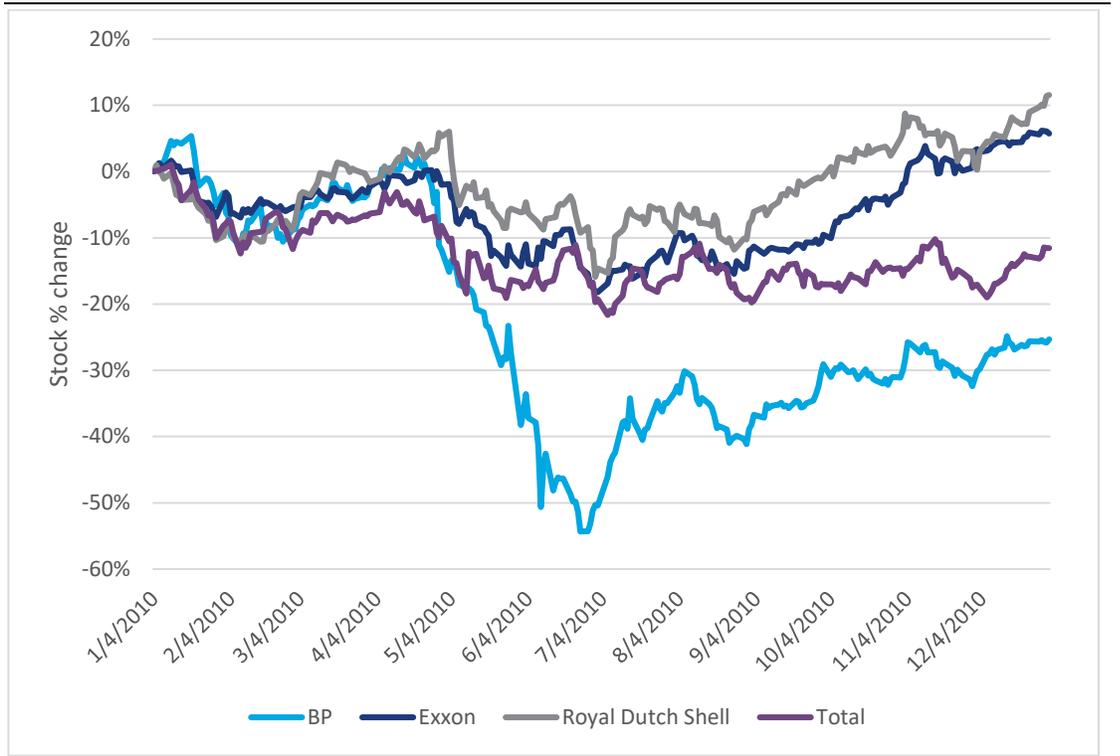


Governance is increasingly seen as an important indicator of quality

The global financial crisis of 2007-08 has increased awareness of the consequences of poor governance. A survey completed by BSR during the financial crisis found that 77% of asset managers questioned believed the financial crisis would increase asset owners' focus on , MLgovernance and transparency. Similarly, ongoing allegations revealing cultures of sexual harassment as well as conversations around social responsibility at companies like Uber, Facebook, and Google have increased the awareness of governance as an important indicator of investments' quality.

The BP oil spill in 2010 offered another difficult lesson for investors. ESG research before the accident suggested that BP might have been poorly positioned; MSCI ESG research ranked BP in the bottom quartile of the oil & gas sector for health and safety in 2009 and removed BP from their ESG indices in 2008-2009 because of poor safety practices. Investigations following the catastrophe highlighted a range of process and governance failures leading up to the spill. In response to the Deepwater Horizon catastrophe, which created \$61 billion in liabilities for the company, the stock dropped more than 50% (Figure 4), and still has not fully recovered.

Figure 4: BP stock % change over 2010



Source: Bloomberg, Cornerstone Capital Group



Key players

The sustainability ecosystem encompasses markets, civil society, and states, all of whom help shape decisions, best practices, and financial outcomes. We present the main participants in each category:

- Investment value chain: beneficiaries and owners, asset managers, and corporations
- Regulators: international to local
- Professional associations and civil society
- Transparency associations: data providers, exchanges, rating agencies and indexes
- Advisors: consultants, attorneys and accountants

While each group of players has its own motivations and roles, the growth of impact-driven investing derives from the asset owners. The capital and its financial returns belong to the asset owners (e.g., individuals and institutions such as pension funds). Asset owners have driven this style of investing since the origins of “negative screens” in the 18th century.

The sustainability ecosystem has evolved around the demands of these asset owners. A 2016 study by the Forum for Sustainable and Responsible Investment found that 85% of managers who incorporated ESG analysis did so because of client demand⁷. Managers deploy asset owners’ capital and have used the demand for impact to create new products, which in turn has spurred the formation of professional and transparency associations. We expect the ecosystem to continue to grow in tandem with demand for impact-driven investing.

The sustainability ecosystem has evolved around the demands of asset owners

Investment value chain

Asset owners and beneficiaries

Asset owners, which for the purpose of this report we define as institutions acting on behalf of the ultimate (individual) investor, have been instrumental in integrating impact concerns into their investment philosophies. The rising awareness of the potential social and environmental impacts of economic activities, poor governance, and systemic risks has led to the development of different investment strategies.

Asset owners who have provided leadership by publicly incorporated ESG into their investment practices include pension funds and retirement systems such as CalPERS, CalSTRS, New York State Common Retirement Fund, and TIAA-CREF; sovereign wealth funds like the Government Pension Fund of Norway; and high net worth individuals and foundations.

In the 1970s and 1980s, higher-education endowment funds played a crucial role in the development of “investor responsibility” around issues such as the Vietnam War and South African apartheid. More recently, asset owners have built coalitions to invest around certain

⁷ http://www.ussif.org/files/Trends/US%20SIF%202016%20Trends%20Overview_Investment%20Managers.pdf



environmental and social impact themes. Confluence Philanthropy and Mission Investors Exchange, for instance, bring foundations, family offices and private investors together to invest in themes such as climate change.

Asset managers

Asset managers allocate funds from asset owners to corporations and other financial instruments. As a crucial link in the investment process, asset managers have the delicate task of balancing short-term market performance demands with the longer-term investment philosophies of their clients. However, many managers have not yet fully incorporated ESG criteria into their approach, citing the difficulty in defining, then monitoring and measuring, impact alongside financial performance.

Some managers incorporate ESG on the premise that sustainability is about good management doing good business for good investment returns

Some managers do explicitly incorporate ESG assessments on the premise that sustainability is about good management doing good business for good investment returns. Their motivation originates partly from the demands of the asset owners, but also from their belief that intelligent integration of ESG criteria in the investment process leads to more well-informed decision-making and potentially stronger financial results.

Corporations

Corporations generate goods, services, and employment opportunities, adding value for their customers, employees, shareholders and civil society. Corporations have started accounting for externalities⁸ and seeking positive impact in the same way as institutional asset owners have done for their beneficiaries.

Increasing sustainability reporting is one sign of corporate progress. In 2016, two decades after the introduction of extra-financial reporting⁹, over 80% of S&P 500 companies reported on their sustainability performance (Figure 5). Moreover, an increasing number of corporations are embedding quantifiable and time-bound environmental and social goals in their long-term strategies.

However, we note that sustainability reports, which are voluntary disclosures, vary widely in terms of depth and quality. Corporations can decide what information to disclose and how to integrate sustainability as a business driver. We also note that sustainability disclosure tends to drop off with smaller companies, though there are initiatives and tools seeking to remedy the gap.

Two main trends drive sustainable behavior in companies:

- The understanding that better management of social and environmental issues reduces long-term risks; and
- The existence of a market for sustainable products and services.

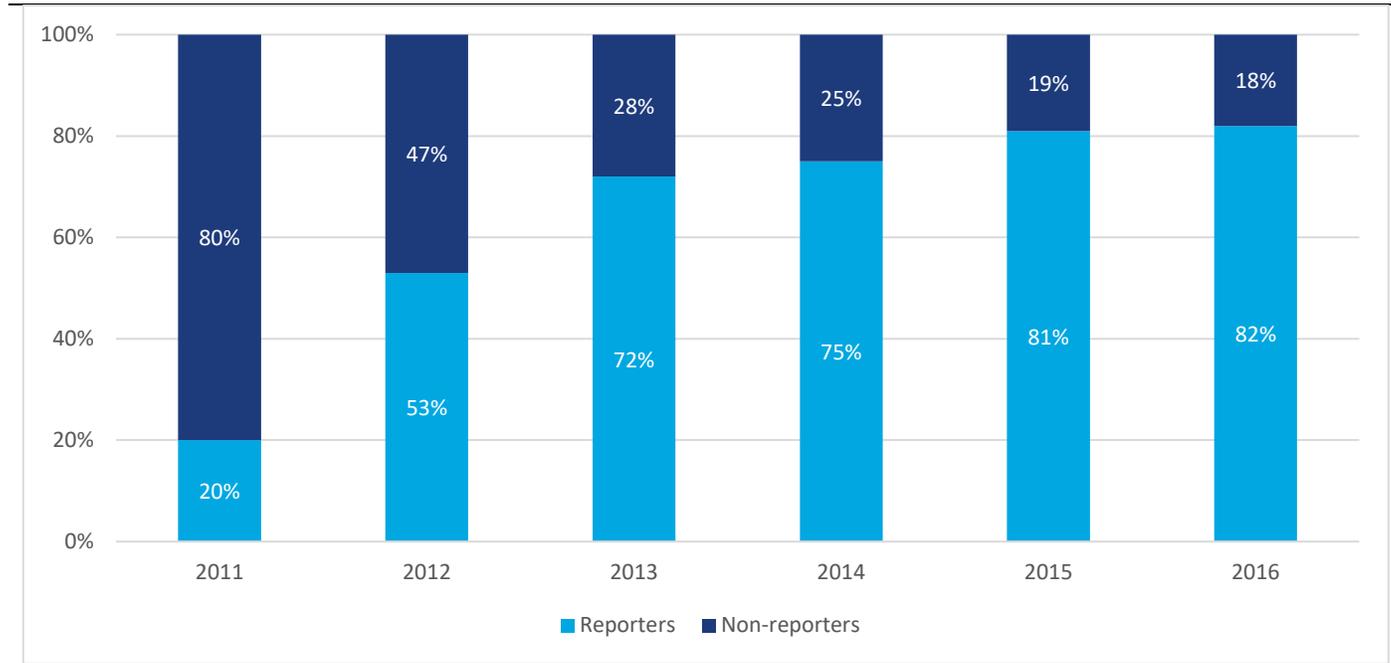
⁸ Externalities are impacts of a business on third parties that are not involved in the business.

⁹ <https://www.globalreporting.org/information/about-gri/what-is-GRI/Pages/default.aspx>



Innovative sustainable business models bring tangible benefits, and some asset owners have been successful in applying pressure to encourage the incorporation of ESG criteria in investment strategies. In consequence, new investment models are beginning to consider not only key financial performance indicators, but also long-term value creation potential using ESG criteria.

Figure 5: Proportion of S&P 500 companies publishing sustainability reports



Source: Governance & Accountability Institute, Cornerstone Capital Group

Regulators

Regulators can help define allowable behaviors for investors under their jurisdiction. For example, the US Department of Labor stated that consideration of ESG criteria was permissible for investors operating under ERISA (the Employee Retirement Income Security Act). In addition, in 2010 the SEC deemed the risks from climate change material enough to require companies to disclose them¹⁰.

For issues that fall under the category of public goods (e.g., climate change and fisheries stocks), markets alone cannot regulate their consumption or the externalities to which they are related. The role of government in incorporating ESG factors into market functioning is therefore crucial, and can range from the traditional approach of creating laws that enforce behavior, to new measures, transparency guidelines, or “comply or explain” mechanisms.

At the international level, the growing number of countries adopting carbon taxes and cap-and-trade systems also illustrates how governments create new basic conditions for markets and integrate ESG factors in the regulatory context of companies and investors. The Paris Climate Accord signed in 2016 represents strengthening global mitigation of and adaption to

¹⁰ <https://www.sec.gov/rules/interp/2010/33-9106.pdf>



climate change. As we outlined in our 2015 note, “[Paris Agreement: Validates national and local actions](#),” the accord opens opportunities for investments through accelerating the “race to the top” in responding to climate change.

Professional forums and NGOs

Many professional organizations help to develop the field of sustainable finance. They play multiple roles, such as establishing standards, coordinating action among disparate investors, companies, and other stakeholders, and lobbying governments for better public policy.

Figure 6 highlights a few of the many professional forums and associations. It is not a comprehensive list, but rather illustrates the range of organizations involved in sustainable finance. Organizations like the Global Impact Investing Network (GIIN) represent numerous other investor organizations¹¹.

Figure 6: Professional organizations

Organization	Mission	Types of members
Ceres	Build sustainability leadership	Asset managers, asset owners, corporations
Euro Sustainable Investor Forum (EuroSIF)	Advance sustainable and responsible investment across Europe	Asset managers, asset owners
Confluence Philanthropy	Advance the practice of mission-aligned investing	Foundations, families, individuals and values-aligned investment managers
Global Impact Investing Network (GIIN)	Increase the scale and effectiveness of impact investing	Asset managers, asset owners
Global Reporting Initiative (GRI)	Help businesses, governments, and other organizations understand the impact of business on sustainability issues	Asset managers, corporations
Interfaith Center on Corporate Responsibility (ICCR)	Build a more just and sustainable world by integrating social values into corporate and investor actions	Asset managers, asset owners, corporations
Mission Investors Exchange	Increase the scale and impact of members’ impact investing practice	Foundations and affiliated advisors
Principles for Responsible Investment (PRI)	Support investor signatories in incorporating ESG factors into their investments	Asset managers, asset owners
Sustainability Accounting Standards Board (SASB)	Set industry-specific standards for corporate sustainability disclosure	Asset managers, corporations
US Forum for Sustainable and Responsible Investment (US SIF)	Advance sustainable, responsible, and impact investing across the US	Asset managers, investment advisors
World Business Council for Sustainable Development (WBCSD)	Create business solutions focusing on positive impact for shareholders, environment, and societies	Corporations

Source: Organizations’ materials, Cornerstone Capital Group

The rise in social media also explains the rise in power of traditional social and environmental activists. Non-governmental organizations (NGOs) have been very active in the past in addressing various social and environmental externalities and advocating for change in business practices. Social media has made their voices much stronger. Many corporations

¹¹ <https://thegiin.org/investors-council>



today work with NGOs to find better ways to address environmental and social issues and to avoid conflicts.

Also, many of today's regulations and market standards have been built with NGO input. A recent example is the work of several NGOs in addressing the problem with palm oil, the most commonly consumed food oil in the world, whose production is directly responsible for deforestation in emerging and developing countries¹².

Data providers, exchanges, rating agencies and indexes

Several information infrastructure service providers now help investors integrate ESG factors by providing both data and analysis on corporate performance across a range of environmental, social and governance indicators. Many investors consider these services a key input into their investment processes. Research methods are not standardized and can be opaque, however, so caution should be exercised in basing investment decisions purely on this data.

Caution should be exercised in basing investment decisions purely on ESG data

These sustainable finance facilitators often provide several types of services: raw ESG data, thematic and industry analyses, company ratings, sustainable indexes. Many of the exchanges have improved their engagement with ESG reporting.

Examples of such players are: Bloomberg, MSCI, RobecoSAM (and the DJSI index), CDP, Sustainalytics, Thomson Reuters/Asset4, Eiris, and Oekom.

Some new players have emerged that are attempting to bring the benefits of big data and the internet/social media to bear on ESG data and sentiments to inform predictive ESG analysis. Examples of these new products include Insight360 and Richmond Global Compass.

Consultants and advisors

Accountants, consultants, attorneys and think tanks are also instrumental in the transition towards sustainable finance. Originally such players were called in to assure the quality of so-called ESG reporting; but their practices have expanded to include consulting on sustainability strategy and management.

Examples include KPMG and PWC on sustainability reporting; Ernst & Young on sustainability and climate change; and McKinsey on resource productivity. The legal firm Freshfields helped the United Nations assess materiality for investors, which helped introduce a new understanding of how ESG can be integrated consistent with an investment manager's fiduciary duty¹³.

¹² <http://www.greenpeace.org/international/en/campaigns/forests/solutions/HCS-Approach/>

¹³ One conclusion of the report states: "In our opinion, it may be a breach of fiduciary duties to fail to take account of ESG considerations that are relevant and to give them appropriate weight, bearing in mind that some important economic analysts and leading financial institutions are satisfied that a strong link between good ESG performance and good financial performance exists". http://www.unepfi.org/fileadmin/documents/freshfields_legal_resp_20051123.pdf A follow-up of this report was published in 2009 by UNEP FI: <http://www.unepfi.org/fileadmin/documents/fiduciaryII.pdf>



Investment strategies designed for impact

Investors employ a wide variety of strategies in seeking positive impact, with diverse objectives and approaches that can be incorporated into most styles and asset classes. Because these strategies are complementary, investors should determine the optimal balance for their portfolios in consultation with a financial advisor experienced with impact-driven portfolios.

Seeks top ESG performers

■ **“Best in class” investing:** Often called “positive screening,” this strategy invests in, or overweights, the top ESG performers within each sector, with the intent to direct capital towards beneficial business strategies. Some managers combine “best in class” analysis with more traditional financial analysis in the hopes of identifying companies that will outperform in the long term. Best in class investing is typically associated with public equities, but can be applied to fixed income as well.

Leverages ownership to effect positive change

■ **Advocacy/engagement:** Shareholder advocacy, sometimes called shareholder engagement, is the use of the shareholder’s ownership stake in a company to effect positive change in corporate policy and practice. Shareholders engage with corporate management in direct dialogue over corporate practices that may not be aligned with shareholder values or long-term performance. Some of the tools of shareholder advocacy include proxy voting, shareholder proposals, and public statements or signed letters by multiple investors on a single sector or issue. For more information on this strategy, see our report [“A Voice in the Boardroom”](#). This strategy is best known as part of a public equities strategy, but can also be employed in fixed income and is particularly powerful in real estate, real assets and private equity, where investors may have substantial influence because they own large stakes.

Considers non-traditional but material issues alongside traditional financial analysis

■ **ESG integration:** ESG integration entails the consideration of non-traditional but material issues alongside traditional financial analysis with the goal of improving investment performance. Typically, managers identify those issues they consider “material” for the investment performance of a company or sector, then incorporate these issues into their analysis along with more traditional financial criteria. For instance, our 2017 reports [“Climate Investing in 2017”](#) and [“The Art of the Possible: Investing to Address Inequality”](#) identify low-carbon investing and income inequality as global trends and outline some relevant investment opportunities. ESG integration is often understood more as a financial than an impact strategy, but widespread adoption of this strategy (especially in combination with advocacy) could have a powerful impact on companies, because corporate managers pay close attention to the investment priorities of their shareholders. ESG integration can be used across public equity, fixed income, and alternative investments, including private equity, real estate, real assets and others.

Excludes activities misaligned with investors’ principles or missions

■ **Screening or divestment:** Many investors choose not to invest in activities that violate their core values. “Negative screens” are criteria that exclude from portfolios companies that engage in activities investors consider misaligned with their core principles or organizational missions. Such screens are best undertaken in partnership with an asset manager experienced in employing ESG screens to mitigate any negative financial impact.



Screens can be used in all asset classes, but are most common in equity and fixed-income strategies.

Dedicates capital to specific issues

■ **Thematic investing:** Investors can direct capital to funds that are dedicated to addressing a specific issue. Examples include renewable energy funds, gender lens investments, certified timberland or green bonds. Thematic investments are narrow in scope, but may have a significant impact on the relevant issue. Thematic investments can be found in any asset class.

Allocates to intermediaries that serve the poor directly

■ **Community development and microfinance:** Investors may deploy capital, sometimes at below-market rates, to financial intermediaries that serve local communities directly. Community Development Financial Institutions (CDFIs) provide a variety of financial services within local communities in the US and developing countries, including business and housing loans, insurance, savings vehicles and other services. This type of investing is considered fixed income or alternative, depending on the type of investment.

It is common for asset managers to employ more than one of the approaches above in a single investment strategy. Before allocating capital to an investment strategy, it is important for investors to understand how a manager is applying ESG criteria, how it is likely to impact the portfolio, and how those approaches align with a manager's experience and capabilities.

Does investing for impact affect financial returns?

The financial implications of investing for impact depends on the strategies employed. Some strategies, such as advocacy, have no direct impact on investment decisions, but may be beneficial to portfolio performance in the long term if they result in positive changes in corporate policy and practice. Others, such as ESG integration, are intended to provide managers with additional information to improve investment decision-making. Thematic investing, done with care, can help diversify portfolios.

Some people believe that negative screens may harm portfolio performance by reducing the investable universe. However, decades of academic research and practical experience suggest that a portfolio with negative screens developed by qualified professionals need not suffer a reduction in financial returns.

Positive relationship between certain ESG indicators and long-term corporate financial performance

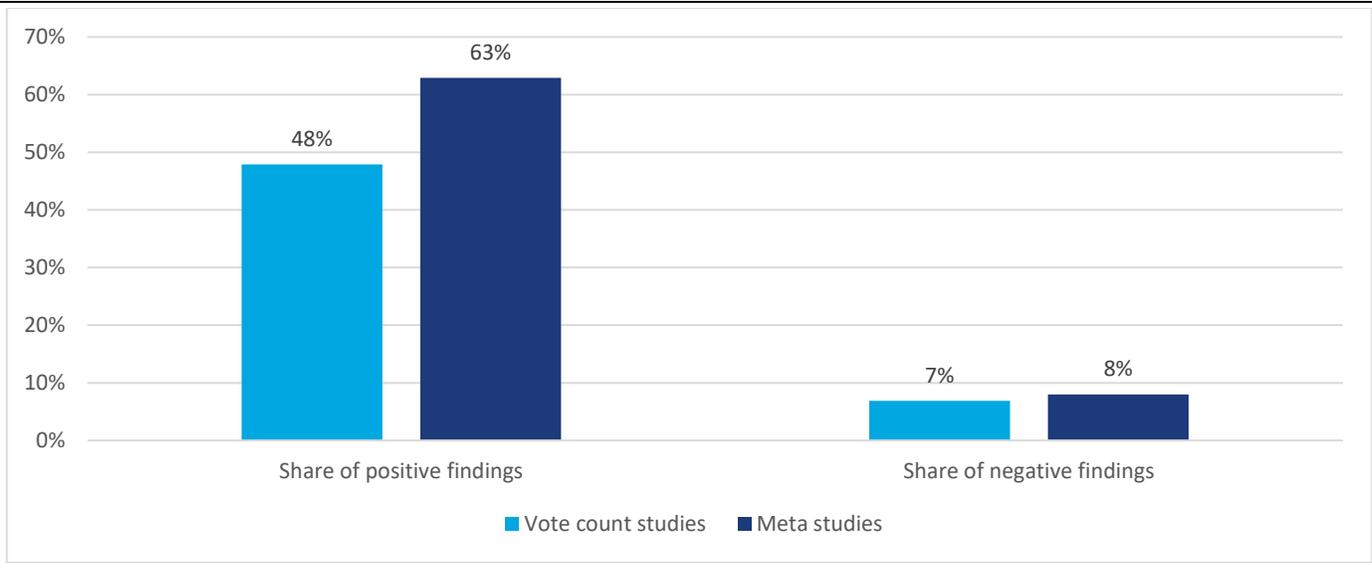
In our 2015 report "[Sustainable Investing: Addressing the Myth of Underperformance](#)," we discuss the development and perception of sustainable investing. Historically, it was assumed to be limited to negative screens and therefore offered a smaller investable universe. It was also assumed that the holdings being screened out would deliver positive relative performance or at least uncorrelated performance.

In recent years, the field has continued to explore the connection between investing for impact and financial performance. The academic literature suggests a positive relationship between certain ESG indicators and long-term corporate financial performance. A comprehensive meta study conducted by Deutsche Asset & Wealth Management in 2015 looked at the findings of



60 studies that reviewed a range of other studies assessing ESG and financial performance¹⁴. Deutsche’s study concluded that a plurality of vote count studies and a majority of meta studies found a positive relationship between ESG and financial performance (Figure 7).

Figure 7: Studies and findings on the correlation of using ESG practices and financial performance



Source: Deutsche Bank, Cornerstone Capital Group

Note: Vote count studies count the number of primary studies with significant positive, negative, and non-significant results and “votes” the category with the highest share as winner. Meta studies amalgamate data from many studies and then conduct statistical analysis to determine whether the results are positive, negative or non-significant.

Investors are improving their understanding of the relevance of ESG analysis and focusing on the most material issues to uncover investment opportunities. A 2016 study by Professors George Serafeim, Mozaffar Khan and Aaron Yoon found that firms with high investment on material issues and low investment on immaterial issues outperformed the benchmark by 4.83 percentage points between 1993 and 2013. In contrast, firms on the opposite end (low investment in material issues and high investment on immaterial issues) underperformed the benchmark by 0.38 percentage points. Firms with low investments in both underperformed by 2.20 percentage points¹⁵.

The ability of ESG analysis to generate above-market financial returns contrasts with the decreasing ability of traditional analysis to accurately forecast returns. As discussed in a previous section, short-term earnings-oriented analysis has seen decreasing returns over the past 30 years as businesses have shifted the way in which they produce value¹⁶.

A summary of key literature can be found in the Appendix.

¹⁴ <http://csr-raadgivning.dk/wp-content/uploads/2016/09/ESG-versus-Corporate-Financial-Performance-Mapping-the-global-landscape-December-2015.pdf>

¹⁵ https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2575912

¹⁶ <https://www.cfapubs.org/doi/abs/10.2469/faj.v73.n4.4>



Common misconceptions

The growth of sustainability as a universal investment objective is hampered by a range of misconceptions. Below we outline the common misconceptions, and offer our rebuttals.

Figure 8: Common misconceptions vs reality

Some investors believe that....	The reality is...
ESG analysis is not serious and not suited to investment strategy.	ESG analysis offers fresh investment insights in a commoditized financial market.
ESG factors that impact shareholder value are difficult to predict or are priced in.	ESG analysis illuminates event-specific opportunities that traditional financial analysis cannot uncover.
ESG data quality is suboptimal and can lead to inconsistent conclusions.	ESG data quality is improving, which provides opportunities for leading analysis. In addition, even financial data quality is sometimes suboptimal.
ESG factors are too long-term for today's investment horizons.	ESG factors can be linked to financial metrics and can be timed for investment horizons.

Source: Cornerstone Capital Group

Is ESG analysis appropriate for an investor that has a responsibility to maximize returns?

Some investors are hesitant to introduce moral judgment into the investment process. This reluctance is likely founded in two separate but equally important notions: 1) the objective of investments should be to earn a return, not to make moral judgments, and 2) investment decisions should be made using hard, objective data.

In addressing the first issue, it's true that some investors incorporate moral judgment into their investment process (e.g., negative screening of companies whose activities they disapprove of). Such considerations may be entirely appropriate for an organization with a well-defined social mission, such as a health care organization that does not wish to profit from tobacco sales. As the Department of Labor stated in Advisory Opinion 98-04A, their guidance does not preclude consideration of collateral benefits, such as those offered by a "socially responsible" fund, in providing beneficiaries with investment options.

Incorporating ESG factors into investment analysis doesn't require a "moral bias"

Regardless, it is inaccurate to claim that incorporating ESG factors into investment analysis requires the presence of a moral bias that lacks a financial rationale. To provide a simple example, the investor who tilts his or her portfolio away from carbon-intensive energy producers and towards companies that provide energy efficiency solutions may not be expressing an "environmentalist" view on climate change. Instead, that investor may be assessing the revenue opportunities, cost efficiencies and risk profiles of these industries, and allocating capital based on where the return on capital is most attractive.

As for the second issue, ESG analysis offers a framework to evaluate issues that traditional financial analysis may not be able to cover. While we appreciate that "traditional" financial analysis can give the impression of objectivity, we note that many factors, often cited as critical to a company's valuation, are subjective. For instance, as previously discussed, there is significant variability when it comes to valuing intangible assets. Even projections of future



earnings and cash flow growth from tangible activities rely on a range of subjective assumptions. As also previously discussed, ESG strategies offer a unique lens to assess emerging issues for companies or sectors, especially as compared to traditional financial analysis. The previously cited Freshfield’s report for the UNEP concluded that “integrating ESG considerations into an investment analysis so as to more reliably predict financial performance is clearly permissible and is arguably required.”¹⁷

How can ESG assessment predict issues that affect shareholder value?

Thoughtful consideration of ESG factors is a lens through which potentially material issues can be identified and investigated. In fact, there have been instances when ESG-related research flagged event risk that had a material effect on long-term stock price. For example, investors that focused on Barrick Gold’s environmental and community issues at its mining operations might have reduced exposure to the company prior to the Chilean court-ordered construction halt at Pascua Lama mine and the corresponding \$5 billion impairment charge in 2013. ESG data also presaged BP’s Deepwater Horizon catastrophe, as discussed earlier in this report. We do not suggest that ESG analysis will *consistently* predict event risk, but rather that it may provide early warning signs for companies and sectors and even broader socioeconomic trends, such as food safety ([Food Safety: In a State of Transformation](#)) or automation ([Retail Automation: Stranded Workers?](#)).

A related misconception is that ESG factors are reflected in stock prices because ESG is a proxy for “quality.” Our extensive experience in the field and our continuing dialogue with investment managers demonstrates clearly to us that ESG factors are correlated with traditional factors associated with quality such as return on invested capital. However, there are other insights afforded by ESG analysis that make it worth viewing independently of quality for many investors and investment managements.

Is ESG data of high enough quality?

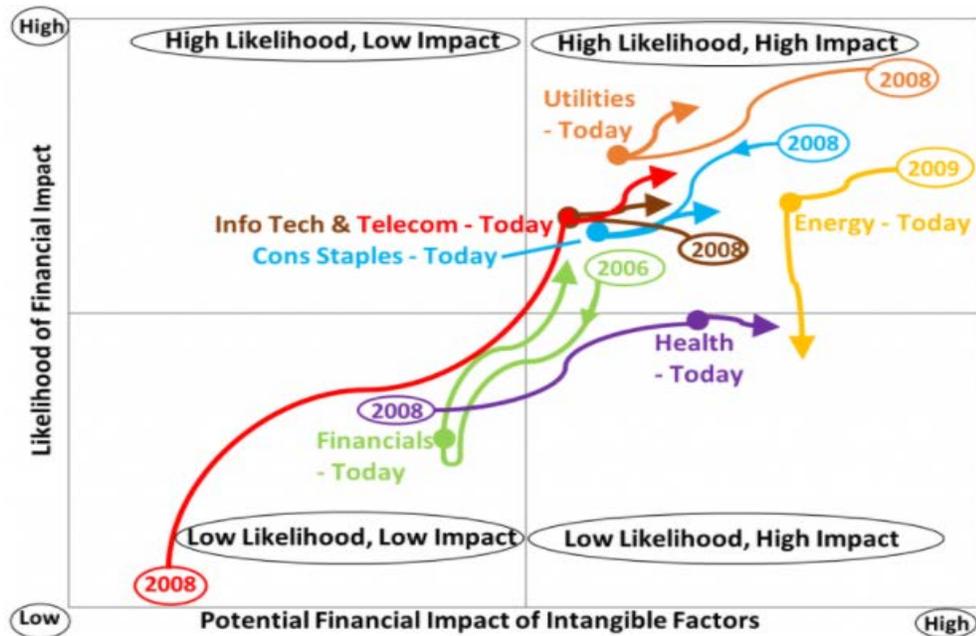
Despite the progress made in reporting, disclosing, and aggregating ESG data, there is still significant room for improvement. Most data is updated annually and there is less data disclosure and collection on smaller companies and in emerging markets. Furthermore, though organizations like the GRI and SASB are working to provide frameworks for reporting, companies are not yet reporting ESG data in a consistent manner. Investors are concerned about utilizing data that isn’t standardized and comparable across companies and industries. Because of these challenges, studies show ratings from different ESG data vendors do, in some cases, lead to different conclusions.

While increased disclosure and standardization of accepted metrics will help resolve these issues over time, we support investors to try to understand the intricacies of ESG data and focus on the most material issues in order to successfully integrate these factors into their investment process. As our 2016 strategy note “[Evolving Lifecycles in an ESG Materiality Matrix](#)” concludes, different ESG factors are material for different sectors, and what is material for each sector changes over time (Figure 9).

¹⁷ <http://www.unepfi.org/fileadmin/documents/fiduciaryII.pdf>



Figure 9: Evolving materiality



Source: Cornerstone Capital Group

Note: intangible factors include data that do not typically appear on income statements or balance sheets. This can include data on air quality, GHG emissions etc.

ESG data requires sector context, as it can provide indicators to how a company within a sector is moving. This provides opportunities for ESG investors to developing leading analyses that cannot be developed through traditional financial data.

What is the time horizon for impact-driven investing?

A substantial segment of the investor population continues to question the link between ESG factors and financial performance, often citing the perceived disconnect between the long-term nature of ESG issues and the short-term focus of the market. This may be accurate for investors with extremely short holding periods, but broadly speaking, this assessment is perceived rather than real.

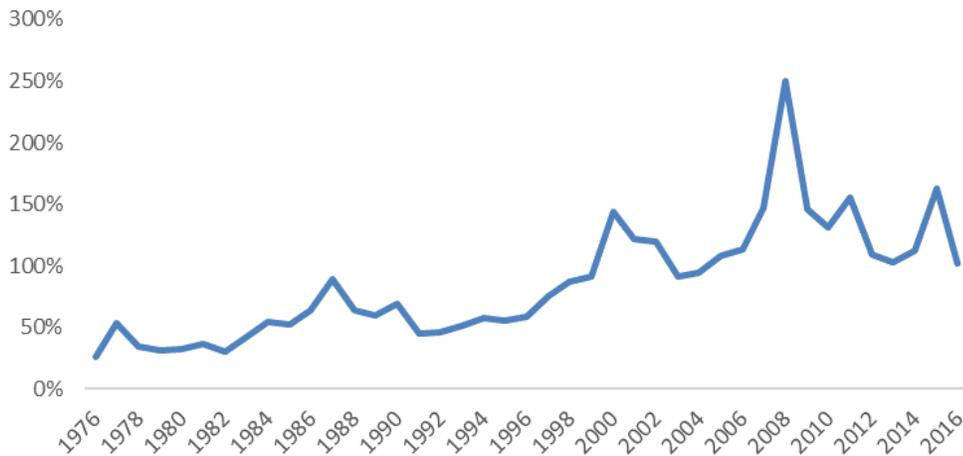
We believe that this misconception is beginning to be addressed and will continue to be as:

- The markets shift from a short-term focus toward the long term;
- Companies' communications efforts evolve to link long-term sustainable innovation to financial metrics; and
- Investors continue to develop frameworks to connect ESG criteria and financial performance.

Data suggest that markets are starting to shift away from the short term

Data suggest that markets are starting to shift away from the short term and towards the long term (Figure 10). A 100% turnover ratio implies a holding period of one year, while a turnover ratio of more than 100% implies a holding period of less than one year.

Figure 10: Turnover ratio of stocks



Source: The World Bank, Cornerstone Capital Group

The turnover ratio increased dramatically in 2008 due to a reduction in market capitalization associated with the global financial crisis, but the turnover rate has since extended its decline past its 2007 level.

Corporations are also encouraging the shift towards a long-term mindset

Corporations are also encouraging the shift towards a long-term mindset. A McKinsey report found that from 2001 to 2015, long-term-oriented firms' revenue grew 47% more than those other firms, with less volatility¹⁸. Leaders in the field are also being more vocal. For instance, Apple CEO Tim Cook has suggested that any investors only interested in the short-term should not buy Apple stock¹⁹.

Conclusion

The growth of sustainability as a core objective for investors shows no signs of slowing. The ecosystem of services for investors has grown significantly since our 2014 report.

With the increasing number and complexity of ESG products, advisors have an important role to play in navigating the intricacies of the different possible approaches. Advisors can assess ESG managers' performance, as well as managers' understanding of and ability to act on the asset owners' interests. This includes articulating both impact and financial performance objectives and employing due diligence to ensure asset owners' capital is deployed accordingly.

¹⁸ <http://www.mckinsey.com/global-themes/long-term-capitalism/where-companies-with-a-long-term-view-outperform-their-peers>

¹⁹ <https://www.forbes.com/sites/stevedenning/2014/03/07/why-tim-cook-doesnt-care-about-the-bloody-roi/#32168fe755f2>



Appendix: Summary of literature review

Study	Key Findings on ESG Performance	Takeaway and Commentary
<i>Corporate Sustainability: First Evidence on Materiality</i> by Mozaffar Khan, George Serafeim, and Aaron Yoon	<ul style="list-style-type: none"> Firms with high investment on material issues and low investment on immaterial issues had an annualized alpha of 4.83% between 1993 and 2013. Firms with low investment in material issues and high investment on immaterial issues had an annualized alpha of -0.38%. 	<ul style="list-style-type: none"> Companies' investment on material issues to their business can positively impact their financial performance It is important for companies to focus on ESG issues that are material to their business
<i>ESG & Corporate Financial Performance: Mapping the global landscape</i> By Deutsche Asset & Wealth Management	<ul style="list-style-type: none"> Only 10% of studies display a negative ESG and corporate financial performance with an overwhelming share of positive results Based on 60 review studies since 1970 	<ul style="list-style-type: none"> Sustainability in the investment process is material and can positively contribute to financial performance
<i>Sustainable Reality: Understanding the Performance of Sustainable Investment Strategies</i> By Morgan Stanley Institute for Sustainability	<ul style="list-style-type: none"> Investing in sustainability meets, and often exceeds, the performance of comparable traditional investments. True on both absolute and risk-adjusted basis, across asset classes and over time. 	<ul style="list-style-type: none"> Overall investment in sustainability exhibits favorable return and risk characteristics. Manager selection is crucial.
<i>Sustainable Investing: Establishing Long-Term Value and Performance</i> By DB Climate Change Advisors	<ul style="list-style-type: none"> 89% of studies show companies with high ESG ratings exhibit financial outperformance. More neutral or mixed performance by SRI funds with exclusionary screens. 	<ul style="list-style-type: none"> Meta-analysis approach has limitations Not all sustainable investing is the same; how a strategy is implemented matters
<i>Does It Pay to be Good? A Meta-Analysis and Redirection of Research on the Relationship Between Corporate Social and Financial Performance</i> By Joshua Margolis, Hillary Anger Elfenbein and James Walsh	<ul style="list-style-type: none"> Mildly positive relationship between corporate social performance (CSP) and corporate financial performance (CFP), with correlation coefficient $r = 0.132$. 	<ul style="list-style-type: none"> Method and data of this study has limitations. There is a need to identify material ESG issues by sector.
<i>The Business Case for Corporate Investment in ESG Practices</i> By The Conference Board	<ul style="list-style-type: none"> For companies, commitment to ESG practices can be rewarded by higher profits and stock return, lower cost of capital and better reputation. 	<ul style="list-style-type: none"> Comprehensive overview on the theory and evidence of the business case for ESG initiatives.
<i>The Impact of Corporate Sustainability on Organizational Processes and Performance</i> By Robert Eccles, Ioannis Ioannou, George Serafeim	<ul style="list-style-type: none"> Between 1993 and 2010, a portfolio of 90 "High Sustainability" companies substantially outperformed a counterpart portfolio of 90 "Low Sustainability" companies. 	<ul style="list-style-type: none"> Return in ESG investing can be significant and varies from sector to sector.
<i>The Long-Term Performance of a Social Investment Universe</i> By Lloyd Kurtz and Dan diBartolomeo	<ul style="list-style-type: none"> Neither benefits nor costs associated with social constraints on a portfolio. 	<ul style="list-style-type: none"> Investing in social responsibility doesn't hurt performance.
<i>Stakeholder Relations and Stock Returns: On Errors in Expectations and Learning</i> By Arian Borghers, Jeroen Derwall, Kees Koedijk and Jenke Hors	<ul style="list-style-type: none"> Risk-adjusted returns can be generated by using a stakeholder-relations index but advantage seems to disappear after 2014. 	<ul style="list-style-type: none"> As some ESG issues become mainstream, strategies that previously generate excess return may cease to work. Some companies' ESG practices may already be priced in.
<i>Financial Constraints on Corporate Goodness</i> Harrison Hong, Jeffrey Kubik and Jose Scheinkman	<ul style="list-style-type: none"> It is not that corporate social responsibility leads to better financial performance; but that less constrained companies spend more on goodness. 	<ul style="list-style-type: none"> Aspects of the apparent link between CSR and financial performance are sometimes disputed and can be explained by other factors



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