Sacrifice Nothing:

A fresh look at investment performance of sustainable and impact strategies by asset class

- Despite decades of competitive returns, a "myth" persists that sustainable and impact investment strategies financially underperform conventional strategies. **The myth should be dead.**

- We recently conducted a fresh review of the academic and practitioner literature on this topic. Sampling from 2,200 reports published over the past few decades, our review provides assurance that **applying an ESG lens is consistent with fiduciary duty.** (We would argue that **it is essential to fiduciary duty**.)

- Our review also highlights that the effect of sustainable and impact strategies on a portfolio will depend upon the asset class, investment style, and especially the skill and expertise of the manager.

- In this note, we seek to describe the consensus view among all studies identified in the bibliography at the end of the report, and where possible we provide some insight into the relevance of specific research for investment decisions. We organize the results according to asset class, and where relevant (i.e., for public equities and fixed income), we look at different applications of ESG analysis. We also highlight the discipline we at Cornerstone take in evaluating the ESG approach of the investment managers we recommend.

What does the academic research say about ESG-driven strategies and financial performance?

	Negative screening	Active ownership	ESG Integration
Public Equity	Many studies done; no negative impact.	Few studies done; positive correlation over long term.	Many studies done; results depend on methodology; some indication ESG integration may reduce volatility.
Fixed Income	Few studies done; results track those for equity.	N/a	Many studies done; strong ESG performance reduces issuers' cost of debt.
Private Equity	Very few studies done; no simple conclusions.	One study suggests lower returns but lower risk; another finds ESG-oriented funds outperformed conventional.	
Real Estate	Many studies done on public real estate investment trusts, few on private funds; "green buildings" provide stronger returns than "brown buildings" over time and seem to hold lower risk, though this is often priced in.		

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*With special thanks to **John Wilson**, Director of Corporate Engagement at Calvert Research and Management, for his contributions to this report.*

Overview

Despite decades of competitive returns, a "myth" persists that sustainable and impact investment strategies financially underperform conventional strategies. For some investors, concerns about financial performance are a deterrence to pursuing the alignment of investments with impact goals.

Academic research should put this to rest. Or, to be blunt: the myth should be dead. More than 2,200 research studies conducted since the 1970s have considered the connection between environmental, social and governance (ESG) criteria and investment performance. At first, these studies examined the most basic questions, such as whether a public equity portfolio that excluded certain companies for ethical reasons would underperform unconstrained portfolios. **The results of these studies have consistently confirmed that social screens do not compromise investment performance**.

Over time, the reach and sophistication of sustainable investing has grown. Most investment managers now offer strategies branded as "sustainable" or "impact," and some integrate ESG data into investment decisions because they believe that it helps them deliver superior performance. Sustainable investing strategies span asset classes, including equity, fixed income and alternatives.

Research into some asset classes is robust; for others, research is still in the early phases.

Researchers have thus turned to studying the diverse approaches that managers use to incorporate ESG criteria beyond just negative screening: positive screens, integration of ESG factors into fundamental investment analysis, and active ownership (sometimes called shareholder engagement), as well as impact investment (intentionally investing in companies and assets that address social and environmental problems through their business models, projects or innovative financing). Research into some asset classes, such as public equities and real estate, is quite robust. For others, especially private equity, research is still in the early phases.

The effect of sustainable and impact strategies on a portfolio will depend upon the asset class, investment style, and especially the skill and expertise of the manager.

We recently conducted a fresh review of the academic literature on this topic. Our review provides assurance that **applying an ESG lens is consistent with fiduciary duty. (In fact, we argue that it is essential to fiduciary duty.)** But it also highlights that the effect of sustainable and impact strategies on a portfolio will depend upon the asset class, investment style, and especially the skill and expertise of the manager.

In this note, we seek to describe the consensus view among all studies identified in the bibliography at the end of the report, and where possible we provide some insight into the relevance of specific research for investment decisions. We also highlight the approach we at Cornerstone take in evaluating the ESG approach of the investment managers we recommend.

Our general findings are as follows:

- Sustainable investing in the equity and fixed income asset classes is fully consistent with fiduciary duty, and investors in these asset classes can and should expect to achieve competitive returns relative to conventional investment vehicles.
- Sustainable investing is associated with improved performance or reduced risk at the firm or security level. Financial performance of *portfolios* deploying ESG analysis depends on how the portfolio is constructed and leads us to conclude that using an "ESG lens" can strengthen investment strategies – *when employed by a skilled manager*.
- Active ownership, especially in public equities, has had a tangible impact on corporate policy and practice, and may improve investment returns.
- For fixed income and real estate, applying ESG criteria is associated with reduced risk relative to the market. There is some evidence for this in public equity as well.
- The robustness of research differs by asset class: within public equity and fixed income, real estate and real assets, the evidence is strong that an ESG focus adds value; the evidence is thinner in private equity because of the diversity of the asset class and the limited number of studies.
- Incorporation of ESG criteria reduces the number of managers and strategies that are available to asset owners. Therefore, due diligence on manager skill, fees and other criteria may be more important for sustainable investors.

Demonstrating the economic value of ESG information will help further its integration into the mainstream, and in turn help expand the universe of sustainable investment opportunities.

Making the "business case" alongside the "ethical case" for pursuing sustainable investment strategies has been key to their growth over the past 20 years, because financial returns remains the top priority for most investors. Demonstrating the economic value of ESG information through systematic research and widespread practical experience will help to further the integration of sustainability and impact considerations into the mainstream of corporate and investment management. Broader inclusion of such considerations will, in turn, help expand the universe of investment opportunities for those seeking impact alongside financial returns.

Public Equity

Negative Screens

"Negative screens" are policies that exclude certain companies from portfolios according to defined criteria, usually based upon the company's product line. Examples of negative screens include tobacco free or fossil fuel free.

Most studies show that **negative screens do not hinder financial performance and are consistent with the fiduciary duty** to maximize risk-adjusted returns.

The capital markets are large, liquid and efficient enough to allow investors to employ screens without reducing diversification for all practical purposes.

Traditionally, financial economists believed that reducing the investable universe would introduce uncompensated risk into portfolio management. But the current view is that the capital markets are large, liquid and efficient enough to allow investors to employ screens without reducing diversification for all practical purposes. In other words, the amount of risk can be substantially reduced with a smaller number of available companies because it is possible to substitute similar names for the excluded companies. That said, investors considering adopting screens that may capture large segments of the market should ensure their investment manager tests assumptions rigorously so that they clearly understand how these screens may affect risk and performance under different market conditions. Screens should also be executed in a manner that avoids undesirable tracking error and manages expected style and sector biases.

In Cornerstone's diligence process, we dig into the manager's process for defining the scope of the screen, the manager's belief about whether screening introduces sector and style biases, the manager's tolerance for tracking error, and how the manager measures the performance impact of screens.

Active Ownership

Active ownership has had a substantial impact on the management of corporations.

Active ownership, sometimes called shareholder engagement, is the use of investors' leverage as owners of companies to effect positive change in corporate governance and sustainability policies. Active ownership has had a substantial impact on the management of corporations. For example, most U.S. corporations have adopted non-discrimination policies for LGBT people as a result of active ownership, and greenhouse gas reporting and reduction targets are now common at companies in all developed markets. The tools of active ownership are proxy voting, dialogue with companies, and public advocacy.

Active ownership is associated with improved corporate performance over time.

There have been a few well-respected studies of the impact of active ownership on financial performance. Those studies have consistently found that successful active ownership - engagement with companies that leads to corporate policy change - is associated with improved corporate performance over the medium and long term. Because of the limited amount of research on this topic, these findings should be considered preliminary.

It is worth noting that researchers were able to document numerous cases of successful engagement, indicating that active ownership can be an effective approach to creating impact on social, environmental and governance issues in a public markets portfolio. The studies also suggest that company shareholders are engaging with companies on issues that matter for long-term financial performance.

Cornerstone takes great care to understand what resources the manager devotes to active ownership, whether in-house or outsourced. We learn how the manager determines priority issues, and whether the manager produces a proxy voting policy and votes consistently in line with this policy. We also consider whether the manager engages with companies explicitly to improve financial performance, and how they measure success.

ESG Integration

Integration assesses corporate operating policies on key issues to provide material information on the potential future performance of companies.

ESG integration is the use of environmental, social and governance information to strengthen investment analysis. Integration assesses corporate operating policies on such issues as employment, environmental stewardship, and customer relations because they believe that this information provides “material,” or useful, information about the potential future performance of companies.

A simple form of integration is “best-in-class” investing, which invests in the highest ESG performers in each industry. More complex strategies combine ESG information with fundamental investment data such as return on investment, market share and capital structure.

At the *company* level, the emerging academic consensus is that corporate social responsibility (a term that encompasses a company's sense of responsibility towards the community and environment in which it operates, as expressed through policies and programs) is associated with superior financial performance. However, studies do not agree on the reasons. Some earlier studies suggested that corporate social responsibility (CSR) does not drive company performance but that companies can afford to invest in CSR policies once they have already become successful. **More recent studies find that companies with strong CSR policies on “material” issues — those that are relevant for their businesses — outperform those whose CSR focuses on issues less directly relevant for the business.** For example, a beverage company that manages its water footprint well is addressing a key operating risk. For a financial services company, a strong water management policy might be viewed positively but have little direct impact on its operating business. This distinction implies that companies can drive company performance by employing sustainable business practices, but only by doing so strategically. In other words, the adoption of sustainable business practices in a manner consistent with firm strategy and business model does improve operating results.

At the *portfolio* level, studies are more mixed. Many studies have found that incorporating ESG information has a positive impact on portfolio returns, while others find no impact on performance. The difference in results may be explained in part by the diversity of research methods used; studies differ by geography, time horizon, integration technique and asset class. These varying results also underscore the importance of understanding a manager’s capabilities and thinking around collecting and incorporating ESG information into their investment decision-making processes.

At the heart of the debate is whether ESG data is already "priced into" the value of the security. Some researchers believe companies that rank highly on key ESG metrics do well on more conventional measures of corporate performance, and therefore the ESG data provides little new information that might affect future returns. Others find that, under certain circumstances, good ESG performance may drive returns. **For example, some research has found that ESG-integrated portfolios may experience reduced volatility, or outperform during market crises, providing investors with a downside buffer.**

Of course, there are no guaranteed techniques to ensure outperformance. Over time, real-world performance is affected by a range of factors, including manager competencies, market effects, cash flows and information costs, making it more difficult to isolate the effect of ESG integration on portfolio return.

In our own analysis of manager's capabilities, we look at their process for integrating ESG into portfolios, who is responsible for the integration of ESG information – the portfolio manager, fundamental analyst, a dedicated ESG analyst, or another approach – the data sources used, the manager's thesis of how ESG adds value to the portfolio and over what time horizon it matters.

Fixed Income

Negative Screening

In evaluating fixed income managers, we examine the types of bias they might introduce via ESG screens and how they address them; whether they have screens for non-corporate securities (e.g., sovereign bonds); and how the manager measures the impact of screens on performance, risk or tracking error.

The few portfolio-level studies of screened fixed income portfolios find that negative screens do not diminish investment performance. The results closely track those for equities, finding that it is possible to achieve full diversification even while employing a reasonable number of screens.

This is not a surprising result: Bonds, which offer a fixed and predictable return, are easier to substitute than equities, whose returns are more volatile.

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ESG Integration

There is a strong consensus that high ESG performance reduces the cost of debt for firms. Many (but not all studies) have found that ESG-integrated funds may perform better in market downturns, but this may depend on geography and other factors.

The sovereign debt of countries that have stronger national institutions by widely accepted measures and higher CSR performance among local firms have lower default risk.

Investors interested in green bonds should proceed with caution to ensure that their return is consistent with risk.

Green bonds often are expensive relative to similar bonds, in part because they are less risky than conventional bonds with otherwise similar characteristics. However, in some cases they are in high demand because of the growing desire for impact investments. Investors interested in green bonds should proceed with caution to ensure that their return is consistent with risk.

Our evaluation of ESG integration strategies focuses on understanding which factors are most important to a manager's decision-making. We also consider their stated financial objectives of integration (lower volatility, lower default, etc.), whether the fund includes green bonds (and how the manager handles concerns that high demand may suppress yields, and how the manager evaluates non-corporate bonds in an ESG context.

Private Equity

There are numerous sustainable and impact investment strategies for private equity. Some funds employ a thematic approach, selecting companies active in areas such as renewable energy or education that offer enhanced social benefits. Others invest in a wide variety of companies but stay closely engaged in ensuring that their companies adhere to high ethical standards. Frequently, private equity investors get directly involved as board members or in board selection.

Very few studies have been performed on private equity, in part because the diversity of these funds may hamper researchers' ability to form general conclusions about the impact of ESG on performance.

Very few studies have been performed on private equity, in part because the diversity of these funds may hamper researchers' ability to form general conclusions about the impact of ESG on performance.

While the studies generally conclude that using ESG criteria in private equity is consistent with fiduciary duty, the actual results do not permit a simplistic conclusion regarding performance impact. One study concludes that these funds offer lower returns at lower risk than conventional funds and provide portfolio diversification benefits. Another study finds that ESG-oriented private equity funds generally outperformed conventional private equity funds. A third study found that impact venture capital funds underperformed conventional funds, but that impact investors willingly accept these returns to achieve non-financial goals.

Our approach to evaluating private equity funds considers the following issues: how "impact" factors into the manager's pre- and post-investment decision-making; whether the manager takes an active role in the governance of portfolio companies, and whether this includes improving ESG performance and impact; and the manager's view about how ESG supports the long term returns of private equity companies.

Real Estate

The benefits of superior corporate social responsibility (especially environmental performance) in the real estate sector have been well documented for over a decade.

The benefits of superior corporate social responsibility (especially environmental performance) in the real estate sector have been well documented for over a decade. Studies consistently show that "green buildings" (buildings with strong environmental qualities) provide stronger financial returns than "brown buildings" (buildings with weak environmental qualities).

Studies of public Real Estate Investment Trusts (REITs) are inconclusive, but the weight of evidence is that while REITs with strong ESG scores enjoy better operating performance than others, these benefits are already incorporated into the share price of these companies – though "green" REITs seem to experience lower risk relative to conventional REITs. Nevertheless, some caution is advised, since some studies also suggest that the cost of compliance with recognized green building standards may offset the benefits of efficient building management.

Unfortunately, there are few studies of private portfolios, because the information on these strategies is not generally available. However, the research on individual buildings suggests, at least, that investing directly in a portfolio of "brown" buildings with the intention of transforming them may still be a viable real estate investment strategy.

Many real estate investments incorporate labor and community development objectives in addition to financial and environmental goals. The research that we reviewed did not explore the impact of social policies on financial performance, focusing instead on environmental policies which have a more tangible effect on operating results.

Cornerstone's assessment of real estate investment funds considers the material ESG criteria used by the manager, the manager's approach to working with property managers to improve sustainability, and the manager's financial performance expectations for "green" buildings relative to "brown."

Glossary

Sustainable and Responsible Investment (SRI): Investment strategies that intentionally seek to incorporate ethical values into investment decision-making and management.

Environmental, social and governance (ESG): A form of investment analysis that takes into account the impact of corporate decision making on stakeholders and deliberately incorporates both corporate governance and the societal impact of business decisions into investment analysis.

Corporate social responsibility (CSR): Company policies designed to address the effect of corporate activities on stakeholder groups and society as a whole.

Materiality: For investors, the conclusion that a piece of information could be considered among the mix of all information useful for decision making. For companies, material information is useful to inform corporate policy or business decision-making.

Impact investing: investing in companies and assets which address social and environmental problems (above and beyond what conventional market transactions can accomplish), through business models, projects or innovative financing.

Green: Policies that improve the environmental performance of an asset or business.

Negative screen: The decision to exclude a class of companies from investment, usually based on business models that violate the core values of the investor.

Positive screen: The decision to invest in a class of companies based on a perception of positive impact on the environment and/or society.

Active Ownership: The practice of using an investor's ownership stake in companies to influence management to adopt positive social policies through dialogue, proxy voting and filing shareholder resolutions.

ESG integration: The practice of incorporating ESG information into investment decisions alongside conventional predictors of investment performance, with the expectations that ESG information will strengthen the investment analysis from a financial perspective.

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