ESG, SRI, Sustainable, Impact and Mission Aligned Investing – Confused Yet?

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The media has bombarded us with jargon before, but now we are getting an onslaught of information on the benefits of Environmental (E), Social (S), and Governance (G) investing. The approach is not new. Several firms have made it their mission to manage investments with a keen eye toward doing the right thing. The challenges that remain are many. What is the industry standard? How do I measure it? Do I have a process for integrating ESG into my current investment portfolio? How do I know an ESG ETF or ESG fund is an ESG-friendly portfolio? Unfortunately, the industry has not made enough progress here, witnessed by the onslaught of poorly executed solutions. This behavior has only triggered the regulators' alarm bells due to this large-scale "greenwashing" that is currently taking place in the marketplace. For several years, we have managed bespoke ESG portfolios for clients from a total portfolio perspective. We do so with a specific process in place and by tracking measurements on sustainability and investment performance.

Investments in ESG and sustainable solutions have grown exponentially recently due to several factors ranging from a sense of urgency to address climate change to the widening income inequality gap. The scope and reach of what falls under ESG and impact investing are enormous and daunting. There are over 600 different sets of industry standards, along with a lack of accountability. Many ESG portfolios are not ESG-friendly. Why? It is challenging to manage the balance between investment risk and ESG compliance. Recently, large asset management firms have been criticized or censured for advertising ESG investment solutions that do not seem to be based on a solid ESG evaluation process (Greenwashing). Global regulators are focusing on and cracking down on ESG marketing abuses. The demand for ESG, sustainable, and impact investments by investors has been strong. It has been driven by the recent vast adverse effects of climate change, growing social and economic inequality, and a strong desire to approach investing with a dual purpose; to provide for a better financial outcome in the future and a measurable impact on sustainability and inequality.

Our view is that integrating ESG into the investment process is very difficult and very personal. As a result, we believe this approach is not best suited for an off-the-shelf solution such as an ETF or mutual fund. Any attempt to optimize a market index with desirable ESG metrics and compare the results to a market-cap-weighted index is, in our opinion, ill-advised. Adding a pure ESG overlay to an existing index is the same as adding a constraint (a detraction from performance). With ESG investing, one size does not fit all. Your passion may be wind and solar energy, while another investor’s might be water infrastructure. We believe the most prudent way to manage these bespoke mandates is through a customized separately managed account (SMA) approach. It is also crucial that there is a consistent and ongoing approach to measuring sustainability through a set of pre-defined KPIs. This capability and a clearly stated process are what clients are asking for, and are in line with regulators’ expectations.

It's essential that providers of sustainable investments who wish to make an impact should be explicit in stating their values and provide a clear mission statement. Potential clients will first migrate to those firms which share similar values. Also, keep in mind that not every individual holding may pass all the required sustainability screens. What is more important is that the total portfolio meets both financial and sustainability requirements.

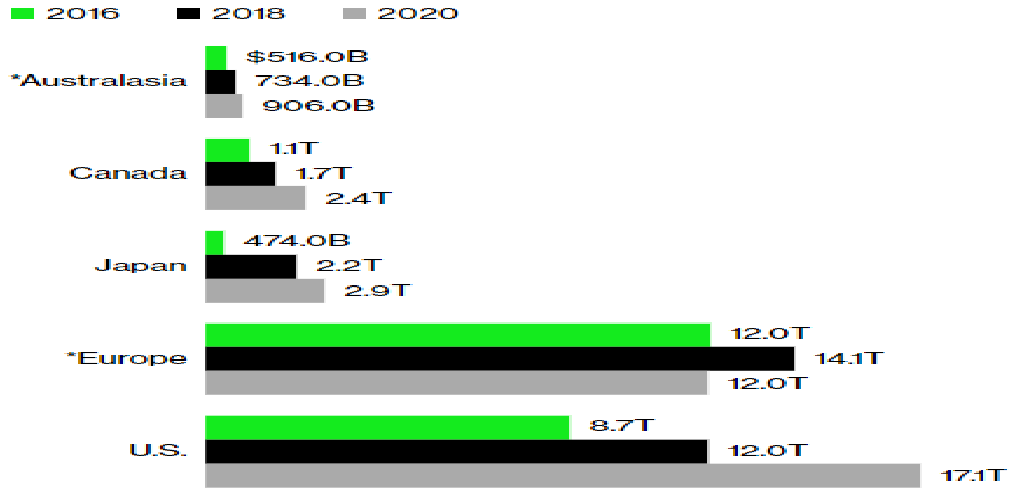
At Palladiem, our core mission has always been to be transparent and conscious of costs, risks, and exposure to environmental, social, and economic risks. We also realize that aligning these elements with each investor's financial and social objectives is crucial. We have managed and advised several advisors and institutions on all these goals and objectives with clarity. We also track and monitor these elements relative to investors' investment policy statements. Clear transparency with investors and regulators: that's our approach. What follows is a summary of Palladiem's philosophy and process as it pertains to ESG.

As with most approaches to portfolio construction and ongoing management, it is necessary to understand the underlying economic and market risk exposures and how they affect investment outcomes over varying business cycles. Adding in ESG exposure is the same; it is a balancing act when measuring the effect on traditional financial exposures. First, with over 600 sets of ESG standards in the marketplace, there is no one standard. One must begin studying and adopting principles and guidelines that cover the broadest reach and have staying power. We adhere to GRI and SASB reporting standards. As asset managers, we follow the principles of the UNPRI (even though we are not formal members). Collectively, these seem the most comprehensive and have some of the longest track records. Adhering to and measuring these standards are only part of the equation. Active proxy voting on behalf of investors' values and mission statement are critical as well. Feeling that you are making a difference is one thing, but knowing you are doing so is essential.

Growing up in the asset management business, we felt it was essential first to understand the market's view of earnings, valuations, and interest rates, rather than any one analyst or analyst firm. This same approach should hold for measuring ESG metrics. Several rating agencies report on the various factors that make up the pillars of E, S, and G. Unfortunately, there are also wide divergences between what should be measured and how those factors should be measured. For this reason alone, we follow a consensus approach here as well. Not only are we relying on a consensus of all the rating provider's output, but we are also pulling financial documents from several external sources via AI (with our partner Owl ESG Analytics). We believe a proper consensus approach to measuring sustainability metrics (KPIs) in all E, S, G areas is the most objective approach. We also believe that investing in ESG or impact investments is very personal; thus, investment portfolios must reflect this. Finally, whether it's ESG, SRI, Sustainable, Impact, or Mission-Aligned Investing, investors are best served by engaging with a dedicated team of professionals who share the same values, mission, and passion for doing good.

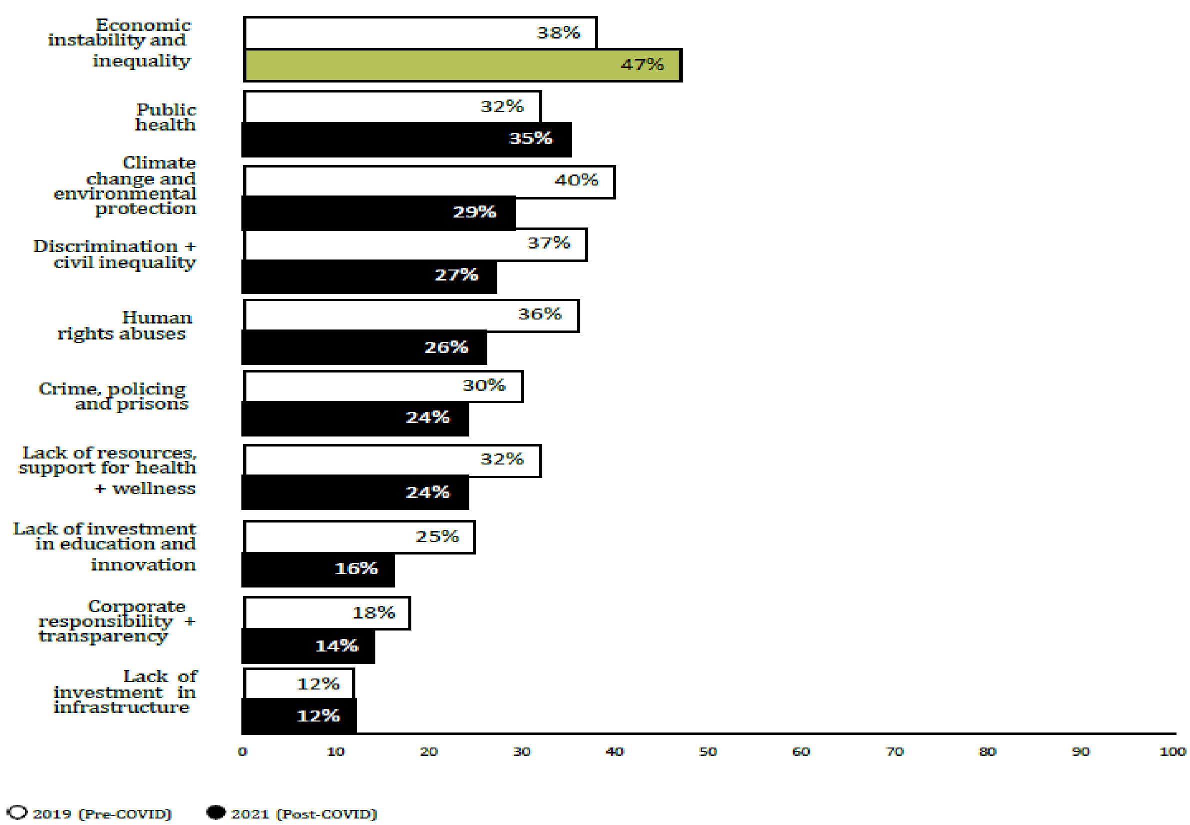
Global Push

Sustainable investing assets have grown more than 50% to $35.3 trillion since 2016



Source: Global Sustainable Investment Review 2020
*Note: Australasia and Europe have enacted significant changes in the way sustainable investment is defined, complicating direct comparisons between regions

Top consumer-identified issues in 2019 and 2021[1]



Source: Jefferies Research