Cornerstone Capital Group

Global Thematic Research

September 24, 2015

Flagship Report: ESG Essentials

Sustainable Investing: Addressing the Myth of Underperformance

©bestdesign36/Crystal Graphics

- **Public debate persists about the performance and best method of integrating Environmental, Social and Governance (ESG) factors into investment decisions.** Despite growing demand for sustainable and impact investment solutions and a body of evidence to support the effectiveness of sustainable investing from a strictly financial perspective, many investors are still unclear about the relationship between ESG factors and financial performance.

- **No financial return trade-off between investing for profit or purpose.** Evidence shows that aligning investments with ESG factors can create financial value for investors, particularly investors who are seeking to invest for impact. The literature review conducted by Cornerstone suggests that there is no reduction in investor returns for investment strategies that appropriately and consistently apply ESG factors.

- **Understanding the range of potential approaches is critical.** The ability to develop and implement an investment strategy that effectively integrates ESG factors to drive value creation requires careful planning as well as an understanding of the variety and effectiveness of approaches. We provide an overview of those styles.

- **Investments do have an impact on broader society, and sustainable investing allows investors to more effectively target and enhance this impact in the context of long-term financial goals.** Investors should consult with their trustees, constituents and advisors to construct a long-term investment strategy compatible with long-term financial and mission-related goals.

Sebastian Vanderzeil
Research Analyst

Craig Metrick
Director, Manager Due Diligence and Thematic Research

Dehao Zheng
Research Associate

Table of Contents

Background

ESG Essentials

In 2014, Cornerstone Capital's report *ESG Essentials – A Guide for Investors* provided a detailed primer for investors and other market participants on the case for integrating ESG factors into investment considerations. The report outlined major drivers that have intensified the use of these criteria in investment analysis:

- **Long-term investing is the most appropriate approach for most investors:** Markets are beginning to recognize the costs of "short-termism" as short-term ownership by active managers has led to lower returns. ESG factors are a critical part of assessing long-term potential risks and opportunities of different companies' operating philosophies.
- **Investments are global:** Global economic forces are creating new paradigms, and the information sought by investors is increasingly aligned with ESG factors. For example, investing in developing markets requires a detailed understanding of company and sovereign corporate governance.
- **Focus on ESG performance by companies is seen as value generating:** Studies show that companies which have integrated ESG performance into operations are generating greater investment returns[1]. Investors are able to identify these companies through the use of an ESG investment lens.
- **Company value is less tangible and new metrics are needed:** Intangible assets are increasingly important in assessing company value—assets such as human capital, intellectual property and "brand" now represent 84% of a company's market value[2], on average. ESG factors provide investors with a clearer window on the value of the intangible assets of companies.

These drivers have led to a rapid growth in ESG as part of mainstream finance.

Obligations for investors

Mission-driven organizations can align their investments with that mission as long as the approach won't knowingly underperform or take unwarranted risks

The primary consideration for many investors and advisors is their fiduciary duty—their obligation to acting as a "prudent" person for the sole benefit of the organization, asset pool or beneficiaries. The US Uniform Prudent Investor Act guidelines state that social investing is not consistent with fiduciary obligations if it *knowingly* would result in below-market returns. Diversification must also play a role in investment decision-making to minimize risk.

Fiduciary duty is often cited as a reason for caution, on the assumption that factoring ESG into investment choices will depress returns. However, in reality

an organization with a particular mission is permitted to invest in a way that expresses and enhances that mission, provided that the approach is not *knowingly* going to underperform alternative approaches or take unwarranted risks.

A range of asset owners such as foundations, endowments, families, pension funds and sovereign wealth funds in the US and around the world are integrating a range of ESG considerations into the day-to-day process of fund management. Approaches range from divesting of tobacco or fossil fuel companies, to investing in renewable energy, community development and diversified portfolios of more sustainable companies. We summarize these approaches in this report, as well as discuss the growing importance of due diligence in selecting mission-oriented investments.

Evidence

ESG rarely has significant negative impact on financial performance and investors do not face a trade-off between "doing good" and "doing well"

To date, analysis on fiduciary duty and sustainable investing has explicitly or implicitly assumed that investors risk underperformance by integrating ESG into decision-making. However, there is significant evidence that issues considered under the umbrella of ESG are material to performance and their integration is neutral at worst and can provide stronger long-term gains.

Our literature analysis provides an overview of the results of integrating ESG considerations into company performance and investments. Key conclusions are:

- Most prominent studies in the field agree that ESG rarely has significant negative impact on financial performance, and the notion that companies and investors have to face a trade-off between "doing good" and "doing well" is not supported by empirical evidence. Rather, a large number of well-defined studies suggest positive impact of ESG on performance.
- However, more work can be undertaken to sharpen the analysis of ESG integration. The current studies, while credible, are unable to be adequately compared as academic and corporate reports vary in their methodology, sample population, and time period—and importantly, how authors define "ESG", "SRI", or "sustainability" investing.

Manager selection is essential to superior performance

- Therefore, for investors, the first step is to acknowledge that not all ESG strategies (screening, integration, advocacy or impact investing) are the same or have the same objectives. Manager selection is essential to superior performance. Investors should have a clear understanding of how asset managers develop and implement their ESG strategies.

A summary of the review is shown in Figure 1, with further detail on individual studies in the Appendix.

Figure 1: Summary of literature review

Study	Key Findings on ESG Performance	Takeaway and Commentary
Sustainable Reality: Understanding the Performance of Sustainable Investment Strategies By Morgan Stanley Institute for Sustainability	• **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.	• Overall investment in sustainability exhibits favorable return and risk characteristics. • **Manager selection is crucial.**
Sustainable Investing: Establishing Long-Term Value and Performance By DB Climate Change Advisors	• **89% of studies show companies with high ESG ratings exhibit financial outperformance.** • More neutral or mixed performance by SRI funds with exclusionary screens.	• Meta-analysis approach has limitations. • **Not all sustainable investing is the same; how a strategy is implemented matters.**
Does It Pay to be Good? A Meta-Analysis and Redirection of Research on the Relationship Between Corporate Social and Financial Performance By Joshua Margolis, Hillary Anger Elfenbein and James Walsh	• Mildly positive relationship between corporate social performance (CSP) and corporate financial performance (CFP), with correlation coefficient r = 0.132.	• Method and data of this study has limitations. • **There is a need to identify material ESG issues by sector.**
The Business Case for Corporate Investment in ESG Practices By The Conference Board	• For companies, commitment to ESG practices can be rewarded by higher profits and stock return, lower cost of capital and better reputation.	• Comprehensive overview on the theory and evidence of the business case for ESG initiatives.
The Impact of Corporate Sustainability on Organizational Processes and Performance By Robert Eccles, Ioannis Ioannou, George Serafeim	• **Between 1993 and 2010, a portfolio of 90 "High Sustainability" companies substantially outperformed a counterpart portfolio of 90 "Low Sustainability" companies.**	• Return in ESG investing can be significant and varies from sector to sector.
The Long-Term Performance of a Social Investment Universe By Lloyd Kurtz and Dan diBartolomeo	• Neither benefits nor costs associated with social constraints on a portfolio.	• Investing in social responsibility doesn't hurt performance.
Stakeholder Relations and Stock Returns: On Errors in Expectations and Learning By Arian Borgers, Jeroen Derwall, Kees Koedijk and Jenke Hors	• Risk-adjusted returns can be generated by using a stakeholder-relations index but advantage seems to disappear after 2014.	• **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.
Financial Constraints on Corporate Goodness Harrison Hong, Jeffrey Kubik and Jose Scheinkman	• It is not that corporate social responsibility leads to better financial performance; but that less constrained companies spend more on "goodness."	• Aspects of the apparent link between CSR and financial performance are sometimes disputed and can be explained by other factors.

Source: Cornerstone Capital Group

Approaches to sustainable investing

There is a range of approaches that investors can use to integrate ESG into their investment decision-making.

Divestment or negative screening

Exclusion of certain companies, securities or assets from the portfolio because of a certain characteristic

Negative screening is the exclusion of certain companies, securities or assets from the portfolio because of a certain characteristic. For example, investors may avoid investing in Tobacco companies[3] or Fossil Fuel companies[4]. Screening may also cut across industries, such as screening out companies that lack gender and minority diversification on boards. Screens may be applied for ethical or moral reasons or for purely financial reasons. Screening is not a new phenomenon, nor is it limited to the sphere of sustainable investing. For example, "Value" investors have "screened out" high P/E companies for decades.

Positive or "best-in-class" investing

Belief that certain sustainability themes present growth investment opportunities

Many investors seek a specific type of alignment or impact believing that certain sustainability themes present growth investment opportunities. This approach can become an important part of an investment strategy, often as a satellite, carve-out, or complement to traditional diversification. There are a variety of strategies that may fit this approach across geographies, asset classes, and performance risk objectives. Varied themes such as renewable energy, microfinance, healthcare and education may be considered under this approach with the goal being to seek investment opportunities in solutions oriented companies and projects.

Integration

Considers the ESG characteristics of a company alongside traditional financial measures

Integration considers the ESG characteristics of a company alongside traditional financial measures. ESG metrics are given a weight in the investment analysis and decision. The focus on superior financial performance means that financial characteristics of the investment retain a majority of the weighting in the analysis. Exactly what sustainability characteristics are considered and how much weight they are given are determined by the investment manager or analyst and vary by strategy, sector and sustainability issues.

Advocacy

Aims to help move specific investments or the investment landscape towards environmental, social or governance related goals

The most common form of advocacy is public equity proxy voting, shareholder proposals and direct engagement with company management. However, advocacy can also take place with debt issuers and public policy makers to help move specific investments or the investment landscape towards environmental, social or governance-related goals. Technological and organizational advancements have lowered the barrier to entry for investors to collaborate with other investors and influence the behavior of their issuers, managers and consultants. Several organizations devote substantial time to supporting and initiating engagement on behalf of their constituents and several vendors offer voting services, research and assistance.

Impact investing

Approaches aiming to accomplish certain objectives in addition to (or in some cases, at least partly at the expense of) financial results

This terminology is often, but not always, associated with approaches aiming to accomplish certain objectives in addition to (or in some cases, at least partly at the expense of) financial results. All investments have impacts, intended or otherwise, but some investments place higher emphasis on social impacts such as social venture capital, community-based investments, program-related and mission-related investments. The dollars that are directed to impact investing are often dollars that might previously been given away as grants, in a philanthropic context, not dollars that might otherwise have been pulled from a core, financially driven asset allocation model.

Next steps

The list above is not exhaustive, and more importantly, none of the approaches described are necessarily mutually exclusive. Many investors pursue some or all of the above strategies and many asset managers utilize multiple approaches in a single strategy. There is tremendous momentum in the sustainable investing field and this is driving numerous exciting innovations in screening, integration, positive investing, impact investing and advocacy.

Every investment strategy should be evaluated carefully considering – in advance – what the intended financial and social impacts are in the context of the end investor's objectives.

Every investment strategy should be evaluated carefully, considering – in advance – what the intended financial and sustainability impacts are in the context of the end investor's objectives. The performance of such strategies should then be measured against the appropriate financial and social or environmental benchmarks that the strategy purported to pursue at the outset.

Investments do have an impact on broader society and sustainable investing allows investors to more effectively target and enhance this impact in the context of long-term financial goals. Articulation of the sustainability and financial goals of an institutional or family portfolio, with assistance from informed advisors, will help ensure that individual investment strategies and overall investment approaches meet expectations.

Investors should consult with their trustees, constituents and advisors to construct a long-term investment strategy compatible with long-term financial and mission-related goals. There is sufficient evidence for sustainability considerations and approaches to support both types of goals.

Appendix: individual study reviews

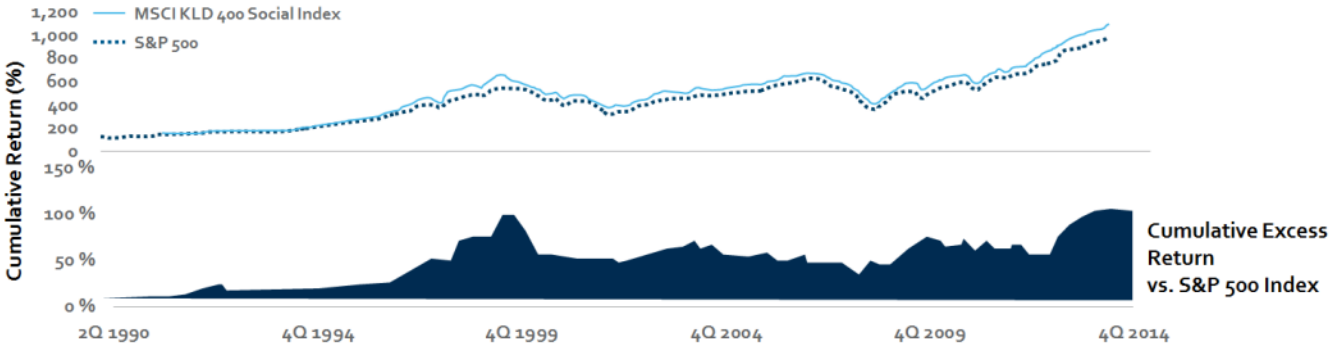
Morgan Stanley Study on Performance

Earlier this year, Morgan Stanley Institute for Sustainability Investing published a report titled *Sustainable Reality, Understanding the Performance of Sustainable Investment Strategies*[5]. The report compares the performance of sustainable investments to that of their traditional peers, focusing on three broad areas:

- individual firm performance;
- benchmark performance; and
- investment fund performance.

On the individual firm level, the report highlights that corporate performance is affected by pursuit of sustainability — notably by reduced costs, increased operational efficiency, as well as higher human resource cost efficiency due to lower employee turnover and higher motivation. Prominent studies reviewed show strong evidence of overall financial and operational outperformance by high sustainability firms.

Figure 2: Index performance – MSCI KLD 400 vs. S&P 500 (July 1990 – December 2014) - USD



	Annualized Return (%)	Standard Deviation (%)	Sharpe Ratio	Beta vs. S&P 500 Index	Annualized Excess Return vs. S&P 500 (%)	Cumulative Excess Return vs. S&P 500 (%)	Alpha vs. S&P 500 Index (%)	Tracking Error vs. S&P 500 Index (%)
MSCI KLD 400 Social Index	10.14	16.80	0.42	1.03	0.45	102.36	0.19	2.68
S&P 500 Index	9.69	16.09	0.41	1.00	0.00	0.00	0.00	0.00

Source: Zephyr Analytics

On the benchmark performance level, as shown in Figure 2, the report compares the long-term performance of the MSCI KLD 400 Social Index to the S&P 500. MSCI KLD 400 is a broad-based index, which only includes firms with high ESG ratings and excludes alcohol, gambling, tobacco, weapons and adult entertainment sectors. From its inception in 1990 through 2014, the index achieved an excess annualized return compared to the S&P 500, supporting the view that appropriate integration of ESG factors into investments does not harm investment performance.

On the investment fund level, the report examines performance data from 10,228 open-end mutual funds and 2,874 Separately Management Accounts (SMAs), and finds that the performance of US-based sustainable funds have usually met, and often exceeded, the performance of traditional counterparts, both in absolute and risk-adjusted terms.

DB Climate Change Advisors Meta-Study

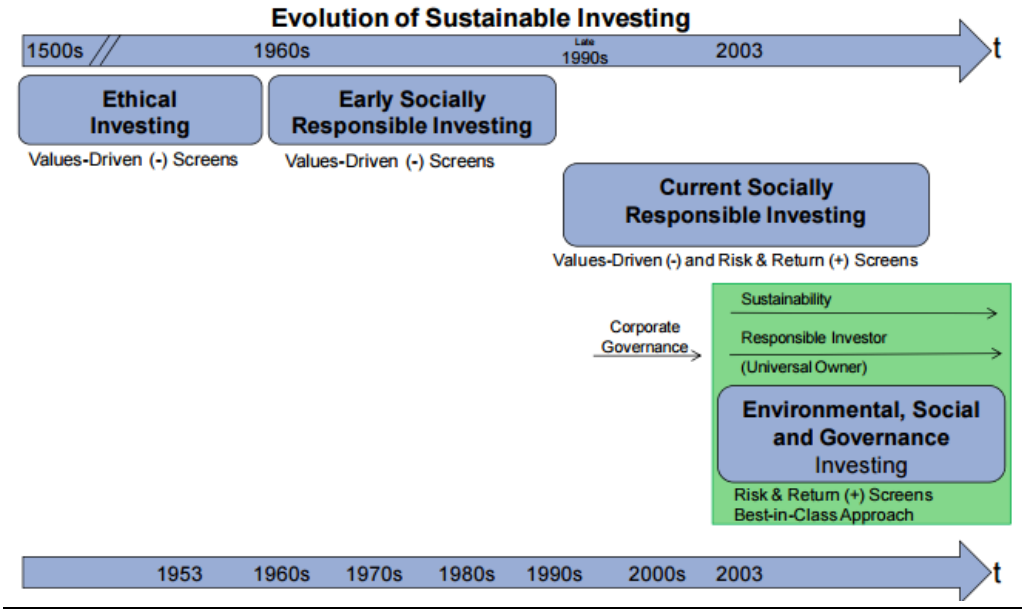
Deutsche Bank Climate Change Advisors (DBCCA) published a meta-study titled *Sustainable Investing: Establishing Long-Term Value and Performance*[6]. The 2012 study reviewed more than 100 academic studies of sustainable investing, and examined and categorized 56 research papers and others. The report found that "Corporate Social Responsibility" (CSR) and especially "Environmental, Social and Governance" (ESG) investing are correlated with superior risk-adjusted returns, while "Socially Responsible Investing" (SRI), essentially exclusionary strategies based on ethical considerations, does not tend to either outperform or underperform.

The evolution of different approaches (SRI, CSR and ESG) is shown in Figure 3.

The report found the following:

- 100% of the academic studies agree that companies with high ratings for CSR and ESG factors have a lower costs of capital in terms of debt (loans and bonds) and equity.
- 89% of the studies examined show that companies with high ratings for ESG factors exhibit market-based outperformance, while 85% of the studies show that these types of companies exhibit accounting-based outperformance.
- The single most important ESG factors, and the most looked at by academics to date, is Governance.
- SRI fund managers have struggled to capture outperformance in the broad SRI category but they have, at least, not lost money in the attempt.

Figure 3: Evolution of Sustainable Investing



Source: DBCCA, 2012

These results are positive for ESG. However, there are several factors which should be acknowledged. Research pieces on sustainability investing and performance could suffer from publishing bias if studies with negative or insignificant results are less likely to be published. Also, treating the validity of all reports as equal ignores differences in method, data sample, time period, qualifications and justifications for the authors' chosen approaches. Finally, the conclusion of the report should be that the return from these types of investments depend on managers and their approach.

Corporate Social and Financial Performance Meta-Analysis

Joshua Margolis of Harvard Business School, Hillary Anger Elfenbein of Haas School of Business, and James Walsh of Ross School of Business published a research piece titled *Does it Pay to be Good? A Meta-Analysis and Redirection of Research on the Relationship Between Corporate Social and Financial Performanc*e. The study summarizes the results of 167 papers published between 1972 and 2007 on the empirical link between corporate social performance (CSP) and corporate financial performance (CFP). The study found a mildly positive relationship. The authors also identified nine categories of CSP, and examined the strength of association of each on CFP. They found that the effect is largest for categories identified as charitable contributions, revealed misdeeds, and environmental performance.

A key limitation of this study is that it combines a number of different CSP strategies with different objectives into a single statistical analysis. But there are material differences between the size, intent and timeframe for different CSP strategies. The results, therefore, should not be considered authoritative and the authors concede that the results of the paper should be considered "approximate and descriptive rather than precise statistical tests."

The results of the nine specific areas of CSP serve as a guide for future analysis on material ESG issues that impact financial performance, and the authors importantly acknowledge that the ambiguity in the direction of causality between CSP and CFP should invite further investigation.

The Conference Board Business Case for ESG

The Conference Board published a report titled *The Business Case for Corporate Investment in ESG Practices* as a review of empirical research on the return on corporate investment in ESG initiatives[7]. The review found that strong business cases exist for firms to invest in ESG initiatives. The researchers categorized the return on investment in ESG in five key areas:

- enhancing market and accounting performance;
- lowering the cost of capital;
- engagement with key shareholders;
- improving business reputation; and
- instigating product innovation and fostering new revenue growth.

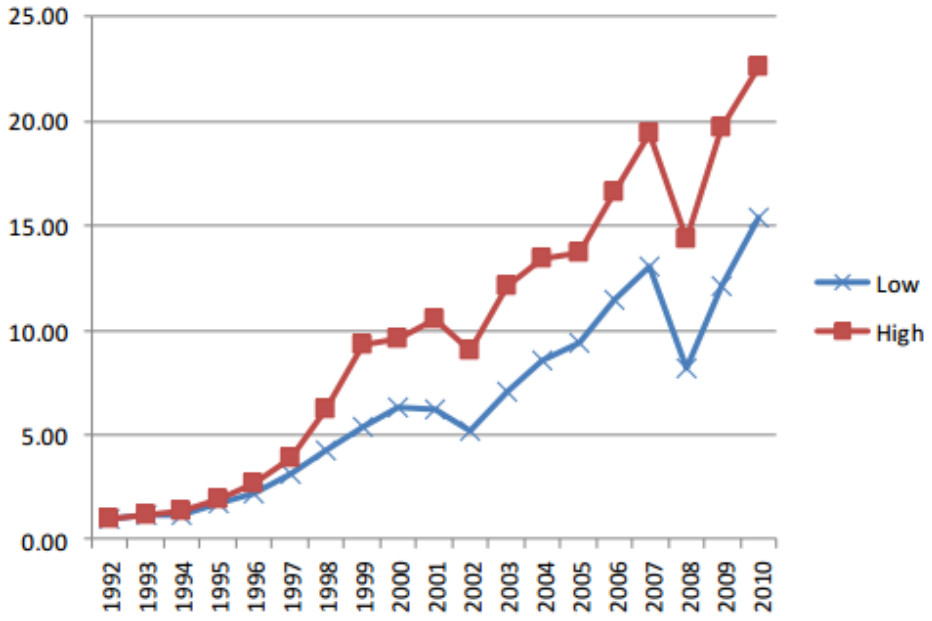
The study found that companies committed to ESG can be rewarded with higher profits and stock returns, a lower cost of capital, and better corporate reputation. It should be noted that the limitations of the report include the heterogeneous group of studies reviewed, shortcomings of meta-studies and the challenges of an evolving business context.

The Impact of Corporate Sustainability on Organizational Processes and Performance

In 2012, Robert Eccles of Harvard Business School, Ioannis Ioannou of London Business School, and Geroge Serafeim of Harvard Business School published a paper titled *The Impact of Corporate Sustainability on Organizational Processes and Performance*. The study examines both the organizational and performance implications of companies' integration of social and environmental policies. The authors term 90 companies that voluntarily adopted a substantial number of environmental and social policies by 1993 as *High Sustainability* companies, while calling 90 other companies that operate in the same sector and were statistically the same in size, corporate structure, operating performance and growth opportunities in 1993 but didn't adopt these policies *Low Sustainability* companies. The study finds that, compared to *Low Sustainability* companies, *High Sustainability* companies:

- tend to have boards of directors formally responsible for sustainability and executive compensation incentives tied to sustainability metrics;
- are more likely to have an established process for stakeholder engagement, to be long-term oriented, and to exhibit higher measurement and disclosure of nonfinancial information; and
- significantly outperform over the long term, both in stock market and accounting performance.

Figure 4: Growth of $1 invested in the stock market in value-weighted portfolios



Source: Eccles et al, 2012

In addition, among all *High Sustainability* companies, those that operate in business-to-consumer (B2C) sectors, where competition is driven by brand and reputation, and where firms' products depend on extracting large amounts of natural resources, outperform their respective counterparts.

Other studies

Some other studies conclude that social investing is neutral for performance when compared to traditional approaches. Lloyd Kurtz and Dan di Bartolomeo published a study titled *The Long-Term Performance of a Social Investment Universe*[8] that examined the risk and return characteristics of the MSCI KLD 400 from 1990 through 2010, benchmarking the S&P 500. The study found that there are neither benefits nor costs associated with social constraints on a portfolio and that social responsibility is still a free good.

In other cases, specific ESG issues have integrated into mainstream investors' investment decisions, and the issues have priced into the valuation and may no longer generate abnormal returns. Arian Borgers, Jeroen Derwall, Kees Koedijk and Jenke Horst authored a report titled *Stakeholder Relations and Stock Returns: On Errors in Expectations and Learning*[9]. The research shows that significant risk-adjusted returns can be generated by using a stakeholder-relations index over the period 1992-2004. However, once other companies recognized that better stakeholder relations improved performance, the surge in shareholder proposals on shareholder issues and CSR reports publication by companies coincided with a reduction in the valuation differences on this basis.

Separately, rather than corporate social responsibility leading to better financial performance, some argue that less constrained companies spend more on 'goodness'. Harrison Hong, Jeffrey Kubik and Jose Scheinkman published a report titled *Financial Constraints on Corporate Goodness,* in which a model is developed to understand how "corporate goodness" varies with financial constraints[10]. The authors confirm that "goodness spending is more sensitive to financial slack than is the case for capital and R&D expenditure." However, this argument does not necessarily present a challenge to the theoretical justification for ESG investing. Despite the direction of causal relationship, as long as correlation between higher profitability and higher ESG performance exists, it remains good indication for investors to identify best-in-class companies.

Sources cited in this report

[1] Tonello, M, 2015, Corporate Investment in ESG Practices, Harvard law School Forum on Corporate Governance and Financial Regulation, http://corpgov.law.harvard.edu/2015/08/05/corporate-investment-in-esg-practices/#more-71271

[2] Ocean Tomo, 2015, Annual Study of Intangible Asset Market Value, http://www.oceantomo.com/blog/2015/03-05-ocean-tomo-2015-intangible-asset-market-value/

[3] http://www.ttac.org/services/college/campus/case_study_briefs/University_of_Michigan.pdf

[4] http://blogs.newschool.edu/news/2015/01/the-new-school-submits-bold-plan-to-tackle-climate-change/#.VeoUlLOFOUm

[5] Morgan Stanley, 2015, Sustainable Reality: Understanding the Performance of Sustainable Investment Strategies, https://www.morganstanley.com/sustainableinvesting/pdf/sustainable-reality.pdf

[6] DB Climate Change Advisors, 2012, Sustainable Investing: Establishing Long-Term value and Performance, https://institutional.deutscheawm.com/content/_media/Sustainable_Investing_2012.pdf

[7] Tonello, M, 2015, Corporate Investment in ESG Practices, Harvard law School Forum on Corporate Governance and Financial Regulation, http://corpgov.law.harvard.edu/2015/08/05/corporate-investment-in-esg-practices/#more-71271

[8] Kurtz et al, 2011, The Long-Term Performance of a Social Investment Universe, http://www.iijournals.com/doi/abs/10.3905/joi.2011.20.3.095

[9] Borgers et al, 2013, Stakeholder Relations and Stock Returns: On Errors in Expectations and Learning, http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2222897

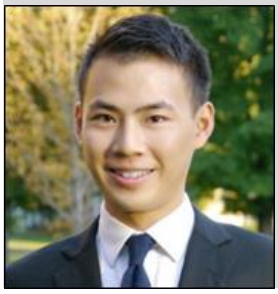
[10] Hong et al, 2012, Financial Constraints on Corporate Goodness, http://econ.columbia.edu/files/econ/financial_constraints_on_corporate_goodness.pdf

Sebastian Vanderzeil is a research analyst with Cornerstone Capital Group. He holds an MBA from New York University's Stern School of Business. Previously, Sebastian was an economic consultant with global technical services group AECOM, where he advised on the development and finance of major infrastructure across Asia and Australia. Sebastian also worked with the Queensland State Government on water and climate issues prior to establishing Australia's first government-owned carbon broker, Ecofund Queensland.

sebastian.vanderzeil@cornerstonecapinc.com

Craig Metrick is Director, Manager Due Diligence and Thematic Research at Cornerstone Capital Group. Previously, Craig was Principal and US Head of Responsible Investment at Mercer, working with a variety of public and private clients. Before joining Mercer, Craig was a Director at the Investor Responsibility Research Center (IRRC), which provided ESG research to institutional investors.
Craig is a Chartered Alternative Investment Analyst, a member of FTSE4Good US Advisory Committee, and served two terms on the Board of Directors of the US Forum for Sustainable and Responsible Investment (USSIF).

craig.metrick@cornerstonecapinc.com



Andy Zheng is a Research Associate at Cornerstone Capital Group. Andy graduated from Bowdoin College with an interdisciplinary major in Mathematics and Economics and a minor in Visual Arts. He spent his junior year studying abroad at the University of Oxford and the summer prior to that at the Sorbonne in Paris. Andy passed Level I of the CFA Program in January 2014.

dehao.zheng@cornerstonecapinc.com