

Kenneth St-Amand
VP, Client Portfolio Manager

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Application of ESG Factors

Environmental, Social, and Governance Data as Tools for Investing in Sustainable Businesses

Tools for Spotting Trouble

Of late, investors and advisors have been overwhelmed with materials and advertisements for new ESG products. So varied are these offerings that ESG has become more of a source of confusion than simply a set of tools for discovering new investment ideas or for managing portfolio risk. ESG is not charity; it's not feel-good investing; and it's not a call for divestment.

ESG is a set of factors one can use to determine the quality and growth potential of an individual company while providing potentially positive environmental and social impacts. It is an analytic tool that a rational investor might wish to use to determine the sustainability of a given company. The best way to understand this is to go through a hypothetical investment process.

The Rational, Hypothetical

Let's imagine an investor who has noticed a pattern. She notices that individuals like to treat themselves to small luxuries during economic hardship. She confirms her thesis by examining stock market data across various economic environments looking at manufacturers of confectioners, like chocolate and hard candy. She confirms for herself that these companies do quite well shortly after major market corrections -- the sort that lead to recession and unemployment.

She then begins to examine the fundamentals of makers of these little luxuries looking for the best of the best candy makers. She would like to see financial stability, a controlling stake of the market, and difficult to replicate competitive advantages.

She concludes from data garnered from stock markets and data gathered from financial statements that she has found the best company to hold during what she believes is a coming recession.

Trouble in Paradise

However, her analysis does not include real world issues.

An **environmental** lens would tell her that the company has terrible water management practices in a part of the world with strained water tables.

A **social** lens would tell her that the company has several harassment cases levied against its executives.

A **governance** lens would tell her that the company has super-voting-rights preferred stock owned by only a handful of individuals -- one of which is both president and chairman.

A rational investor might be disinclined to invest in a company that has a huge expense looming in the near future, like a management systems overhaul. Furthermore, that investor may be concerned that impending lawsuits against the executives will be costly and ultimately paid for by the shareholders. Lastly, an entrenched voting body and management team may be disinclined to address the specific issues in an effective and transparent fashion.

While all other data suggest that this business should grow, the environmental, social, and governance examination tells her otherwise. This business is what we at Mirova would call unsustainable.

How We Put It Together

This sort of analysis is similar to how we use ESG at Mirova, with dual emphasis on long-term returns and positive impact. We look for companies that have positive exposure to long-term trends. We look for companies that have minimal negative environmental externalities, minimal negative social externalities, and have good governance. Those long-term trends we are currently follow are: population growth; urbanization; emerging middle-class; aging population; technological advances; strained resources (like water and food); climate change; and changing financial systems.

We seek to invest in this changing world by looking for companies driving positive trends, companies providing solutions to negative trends, or companies neutral to positive or negative trends but provide a social service or drive innovation.

We believe that companies with good environmental, social, and governance practices and policies are all the more likely to survive over the long term. Lastly we look for companies with good fundamentals that have, what we believe to be, the attributes of a company that will grow over the next 36 months. These are, what we believe, the sort of companies a rational investor would wish to own.

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**NATIXIS ASSET MANAGEMENT US**

399 Boylston Street, Boston, MA 02116
Tel: 212-632-2800

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