Aberdeen Standard Investments

The elements of ESG

April 2018

"Chemistry, unlike other sciences, sprang originally from delusions and superstitions, and was at its commencement exactly on a par with magic and astrology."

Thomas Thomson, Scottish chemist, 1773-1852

Introduction

Although it wasn't until the 16th century that chemistry began to separate itself from its predecessor, alchemy, its origins date back to the beginning of humanity. Chemists began using the scientific method to conduct experiments and prove the validity of various theories. Today, this branch of science is firmly established alongside physics, biology and other "hard" sciences.

Like chemistry, environmental, social and governance (ESG) concerns have been part of our collective psyche for millennia. But while chemistry includes the study of the elements that make up matter, ESG studies material risks and opportunities that matter for potential investments. But how does one define ESG? And how does the identification of material ESG risks alongside other risks (such as financial risks) support the achievement of long-term investment objectives?

It's time to put aside delusions and superstitions and instead focus on the very real ways ESG investing can help investors, asset managers and individual companies align their interests to create a better portfolio and, ultimately, a better world. As we become more familiar with the elements of ESG, we will learn what differentiates ESG from other types of stewardship, the trends driving the adoption of ESG principles in investment strategies and what investors should look for in an ESG-focused manager.

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Chapter 1

Molecular structure: What is (and isn't) ESG investing?

Let's start with the basics: How does one define ESG investing?

ESG investing focuses on mitigating three types of material risks:

Environmental. Environmental factors relate to how a company views itself with regard to environmental conservation and sustainability. Types of environmental risks and opportunities include a company's energy consumption, waste disposal, land development and carbon footprint, among others.

Social. Social factors deal with a company's relationship with its employees and vendors. Risks and opportunities can include (but aren't limited to) a company's initiatives related to employee health and well-being, and how supplier relationships align with corporate values.

Governance. Corporate governance factors can include the corporate decision-making structure, independence of board members, treatment of minority shareholders, executive compensation and political contributions, among others.

These broad categories are just a starting point for an in-depth ESG risk assessment, but they reveal critical information about a company's values and practices, as well as a number of potential risks that should be identified and managed before investing.

The assessment of ESG-related investment risks shouldn't be confused with socially responsible investing, or SRI.

What isn't ESG?

The assessment of ESG-related investment risks shouldn't be confused with socially responsible investing, or SRI. While SRI and ESG integration both seek to address a variety of ESG concerns such human rights, climate change or business ethics, they differ in the way they are applied to an investment portfolio. In general, criteria for SRI are overarching themes or client-driven requirements that are superimposed on a portfolio. Managers aim to avoid "bad" companies to create a "good" portfolio from a perceived moral perspective.

Investors may want to avoid including certain activities or products within their portfolios, such as tobacco or weapons manufacturing. SRI screens can help weed out these types of investments. SRI criteria can also function as a ranking system among sectors or asset classes, giving preference to those assets with a lower carbon footprint, for example. Funds using SRI techniques establish criteria that managers must abide by within their investment management agreements.

While these techniques can help investors along their journey toward more responsible investing, they typically aren't as comprehensive as full integration of ESG within an investment strategy. Choosing broad-based moral themes to adhere to, or establishing categories of investments that one should avoid, fails to address all of the different questions managers must ask when aiming to include ESG-related issues holistically within their investment philosophy and process. An integrated ESG approach should examine a company's material risks and opportunities with respect to ESG concerns, and these findings should be evaluated alongside financial risks, in order to develop a better idea of the value of the investment opportunity.

Chapter 2

Fundamental properties: Why is ESG important?

We will look at this question from a few different viewpoints: an investor, an asset manager and a company.

Investors: From the perspective of investors, consideration of ESG factors has gone from a nice-to-have to a need-to-have over the past decade. This can be attributed to many different trends. One is a growing awareness of the effects of climate change and other man-made environmental impacts, especially given the number of extreme weather events happening recently. Another is the changing demographics of the global investor base, which increasingly includes more women and millennials, both of whom have been shown to express a greater interest in stewardship. Lastly, recent research has shown that factoring in material ESG risks during the investment process can help generate a high-quality return stream that is likely to be more stable over the long term. This makes sense intuitively, in that it should foster a more in-depth look at potential investment opportunities.

ESG investing among institutions is on the rise. According to a recent survey of institutional investors by State Street Global Advisors, 80% of institutions now incorporate an ESG component within their investment strategies, with more than two-thirds of these institutions stating that the integration of ESG has significantly improved their returns.[1] A survey conducted by BNP Paribas Securities Services finds that while nearly half of these investors have invested 25% or less of their assets in specific ESG strategies, they plan to increase this to 50% or more over the next two years. And asset managers are responding to this increase in demand for ESG products. Of the 80% of asset managers incorporating ESG investing, 40% currently market 25% or less of their funds as either ESG or responsible investing funds. However, more than half (54%) have said they plan to market 50% or more of their funds as ESG products in two years.[2]

For retail investors, increased interest in ESG investing along with the importance placed on fiduciary duty have propelled an expansion in the use of stewardship strategies as well as ESG integration. Many individual investors are giving greater thought to how their investment dollars impact the world around them. A 2015 survey by Morgan Stanley found that 71% of individual investors expressed an interest in sustainable investing, with 65% of individual investors saying they expect that sustainable investing will become more prevalent in the next five years. At the same time, financial advisors are taking their clients' interests in stewardship and ESG issues seriously, with a 2015 SRI conference survey on the views of financial professionals reporting that 73% of financial advisors believe that impact investing would become a "somewhat bigger" or "much bigger" part of their practice over the next five years.[3]

Asset managers: Risk management is becoming ever more important to asset managers as risks develop and evolve within constantly changing markets. Incorporating ESG risks into investment decisions helps asset managers gain a fundamental understanding of the key risks and opportunities associated with each company or asset. All of these risks – including those relating to cybersecurity, supply chain management, regulatory changes and environmental impacts – should be part of the overall analysis of an investment opportunity. Recognizing unique advantages and possible risks of an investment, whether positive or negative, is a critical part of fundamental investing. Understanding material risks related to ESG concerns contributes to a fuller understanding of each potential portfolio holding.

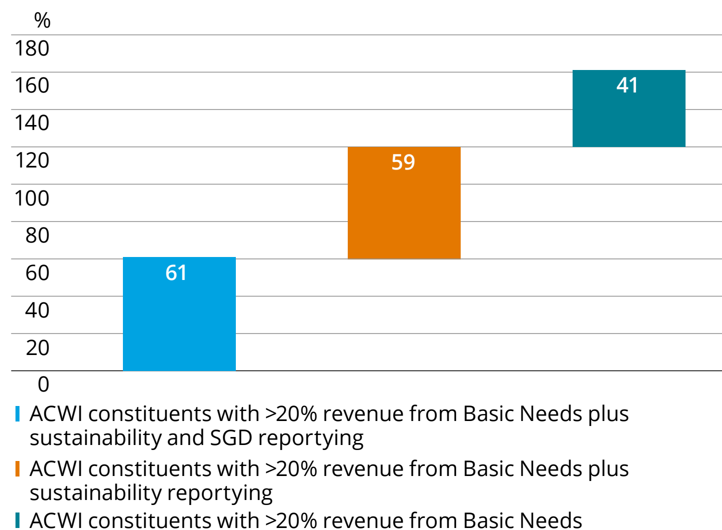
[1] "ESG Institutional Investor Survey: Performing for the Future." State Street Global Advisors, 2017.
[2] Source: BNP Paribas Securities Services, May 2017.
[3] Retail Investors: Rising Interest and Opportunity in Impact Investing." TriLinc Global, 2015.

While many commentators link ESG analysis to "non-financial" analysis or considerations, this view may actually understate the importance of ESG-related factors. Rather, these factors are just as vital to understanding a company's financial health as understanding the company's financial statements, perhaps just not in the very short term. But, if an ESG risk manifests itself over the medium to long term, it will soon have a significant impact on a company's financial condition and its ability to generate returns for investors.

By integrating ESG considerations on a holistic, fundamental basis, investment managers can better price the asset they are investing in. This helps avoid overpaying for an investment. Understanding the individual material issues of an asset helps managers determine the most appropriate weighting for a particular asset within a portfolio. Additionally, full integration of ESG into the investment process helps investors better engage with companies on the issues will have the most significant impacts on their businesses. Finally, ESG integration helps manage the downside risk, or the risk that an asset loses value due to the augmentation of a key risk to the business.

Companies: As a result of greater commitment to ESG and responsible investing from both investors and asset managers, companies are changing their reporting practices to better reflect their commitment to sustainability and other ESG issues. According to a recent roundtable discussion sponsored by Pensions & Investments, less than 25% of the 500 largest companies globally were producing sustainability reports five years ago. As of 2017, over 80% of these companies now produce reports of this kind.[4] The chart below shows increased adoption of ESG reporting within the MSCI ACWI Index.

Focus on Sustainable Development Goals (SDGs) for MSCI ACWI constituents as of December 31, 2016



Source: MSCI ESG Research, December 2016.
For illustrative purposes only.

But simply reporting on sustainability practices is no longer enough. ESG risks are just as important as financial risks, and thus should be given equal consideration. Companies must therefore report their material ESG risks and opportunities and how they plan to manage them. While some companies have adopted best practices, others still continue to dump this information in their sustainability or Corporate Social Responsibility (CSR) reports where it can be easily overlooked.

Still, there is reason to be hopeful that improvements will come in time. Several international bodies, including the Global Reporting Initiative (GRI) and the Sustainable Accounting Standards Board (SASB) are currently advocating for global standards of ESG risk assessments. But this is still a work in progress.

Finally, companies are seeing increased support from their boards regarding a focus on ESG characteristics. According to data from Institutional Shareholder Services, 33% of companies included in the S&P 500 Index have at least one director on their board with experience in corporate social responsibility or socially responsible investment.[5] Changes like these that happen at the very top of the corporate structure are likely to spur a greater drive toward implementing more ESG-friendly objectives.

By integrating ESG considerations on a holistic, fundamental basis, investment managers can better price the asset they are investing in.

[4] "Not Your Parent's ESG." Pensions & Investments, May 2017.
[5] Skroupa, Christopher P. "Company Valuation -- How ESG Integration Is The Future Standard." Forbes. July 12, 2017.

Important events in ESG history timeline

1700s	Quakers, Methodists and other religious groups introduce guidelines for how money should be invested to align with values.
1960s	The rise of the Civil Rights Movement in the U.S. and protests against the Vietnam War coincide with the popularization of mutual fund investing, prompting many investors to think about how to ethically invest their money.
1970s-1990s	Investors divest of companies operating in South Africa in protest of the nation's continuation of apartheid.
1980s	Environmental disasters like the one caused by the Exxon Valdez encourage investors to examine companies' impacts on the natural world.
1990	MSCI creates its suite of ESG indexes.
2000s	Millennials come of age, impacting the investing world through a characteristic need for their daily choices to reflect their values, which are often associated with increased social and environmental awareness.
2006	The United Nations (UN) establishes Principles for Responsible Investment (PRI) "to understand the investment implications of environmental, social and governance issues and to support signatories in integrating these issues into investment and ownership decisions."
2015	A total of 193 member countries adopt the UN's Sustainable Development Goals, a set of 17 goals to end poverty, protect the planet and ensure prosperity for all people, with specific targets to be achieved by 2030.
2016	UN PRI gains more than 1,400 signatories from more than 50 countries around the world, with assets totaling US$59 trillion. The Paris Agreement is introduced for signature in New York, with 195 countries agreeing to help limit carbon emissions in order to fight climate change. Morningstar introduces its sustainability ratings.
2017	China and India are ranked #1 and #2, respectively among the world's most favorable markets for renewable energy development and investment, according to EY's Renewable Energy Country Attractiveness Index.

For illustrative purposes only.

Chapter 3

Distillation and purification: Separating ESG integration from other types of sustainable investment

It's easy to get lost in the myriad terms and types of stewardship-related investing. From SRI to ESG integration to impact investing or simply "green," it helps to define what each of these types of investing encompasses and what makes them different from one another. In a spirit of greater understanding, let's look at what some of the most common terms mean.

ESG: Integrating ESG concerns into the investment process involves assessing the material risks and opportunities derived from a company's environmental, social and governance characteristics, as well as how any potential risks are managed. ESG concerns are equally as important as financial concerns when determining the quality of a company and an asset's true value. These factors can materially impact a company's bottom line, and can have significant implications for risk management and the potential for alpha generation.

Stewardship: Stewardship can encompass values-led actions from a variety of perspectives. As an investor, it can mean deciding how to invest funds, establish an asset allocation, construct a portfolio and set an appropriate holding period. From a corporate standpoint, it can mean doing right by both employees and shareholders. Stewardship issues such as good governance, culture, tax practices, innovation, diversity, labor standards, cyber security, climate change and bribery and corruption, vary in materiality, but they pose challenges and opportunities that must be addressed.

SRI: The SRI acronym can mean "socially responsible investing" or "sustainable and responsible investing." This type of investing may involve using negative screening to avoid investing in certain types of controversial companies or industries, such as alcohol, tobacco or weapons manufacturers, or it might focus on broad certain investment themes. But what is most important to remember about SRI is that it's driven by the client, rather than the investment manager.

Green investing: "Green" investing is defined as investing in such a way that benefits the environment. The rise of "green bonds" to raise funds for renewable energy, conservation of natural resources and other environmentally friendly projects is just one way of how this type of investing is encouraging new segments within asset classes.

Impact investing: This is investing in holdings that are selected not only for their potential for a positive return, but also for their ability to deliver measurable environmental and social impact as part of their business strategy. It is based on the thought that money and resources should be directed towards companies that are actively seeking solutions for environmental issues and social ills. Renewable energy and social housing are just some of the broader industries included in this type of investing.

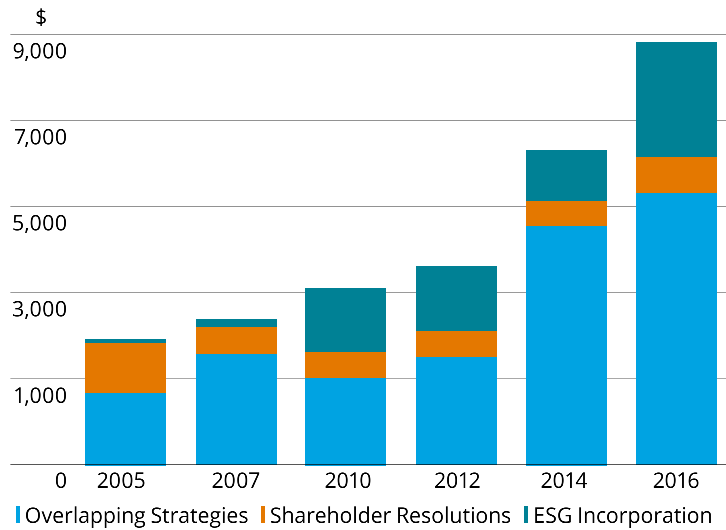
While there are many types of stewardship, they aren't created equal. Each has its own specific nuances that investors should be aware of as they select an approach.

While there are many types of stewardship, they aren't created equal.

Chapter 4

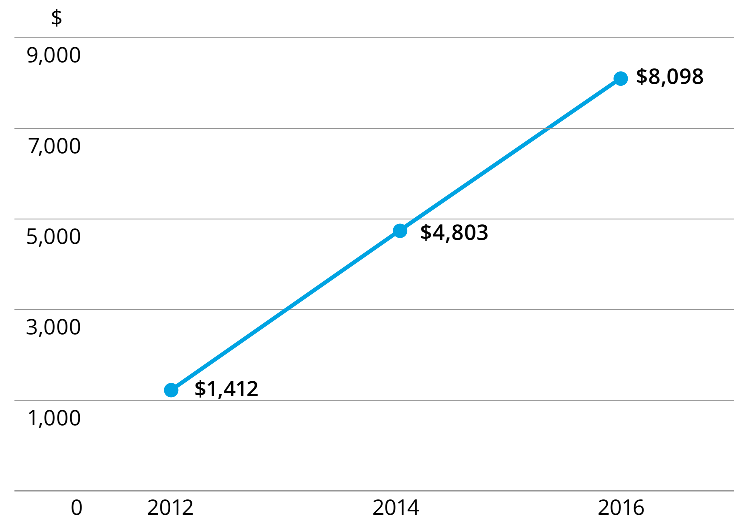
Chain reaction: The rise of stewardship in three charts

Sustainable Investing Growth in the U.S. (billions), 2005-2016



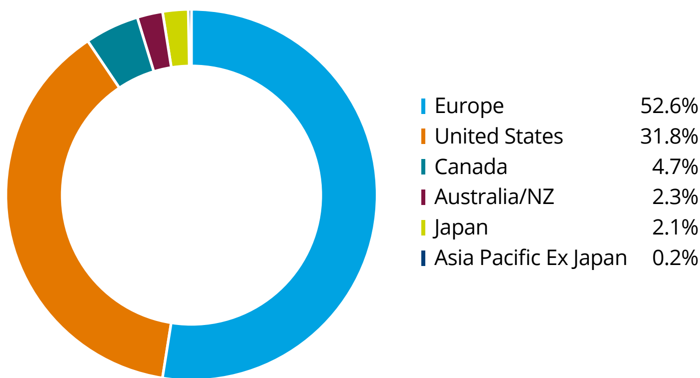
Source: US SIF Foundation, 2016. For illustrative purposes only.

Growth of money manager assets under management incorporated ESG criteria (billions)



Source: US SIF Foundation, 2016. For illustrative purposes only.

Global Sustainable, Responsible and Impact (SRI) assets by region



Source: Global Sustainable Investment Review 2016.
For illustrative purposes only.

Investors' interest in ESG considerations has grown dramatically over the past several years.

Chapter 5

Testing the hypothesis: How does ESG affect investment performance?

What does all of this have to do with investment performance? The good news is that multiple studies conducted over the past several years showed a positive correlation between an emphasis on ESG and investment performance. Here are a few examples:

- A study conducted in 2011 by Alex Edmans and published by The Journal of Financial Economics, which looked at the performance of a value-weighted portfolio of the "100 Best Companies to Work For in America," found that firms with above-average employee satisfaction had overwhelmingly positive returns, as well as earnings surprises.
- A study of the relationship between ESG and corporate fixed income in 2016 by MIT Sloan School of Management and Breckenridge Capital Advisors showed that ESG factors were positively correlated with measures of financial health, including risk, return on assets and leverage ratios. Furthermore, these positive findings were even stronger during times of market turmoil.
- A review of more than 2,000 empirical studies from the 1970s to the present was conducted by Gunnar Friede, Timo Busch and Alexander Bassen in 2015, the results of which were published in The Journal of Sustainable Finance & Investment, to provide a closer look at the relationship between ESG and corporate financial performance (CFP). The study found that ESG and CFP had a non-negative relationship 90% of the time, and that most studies reported positive results.

These are just some of the recent studies that have come out in support of ESG investing. While there are no guarantees of outsized performance, it seems to make sense that having a focus on doing what's right, not only for one's bottom line but also for employees, shareholders and the environment, would lead to a more engaged workforce, mitigation of certain risks and, ultimately, a satisfied investor base. When these elements combine, good intentions seem to reinforce good business results. And all of this is good news for investors.

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Chapter 6

Balancing the equation: How to measure ESG

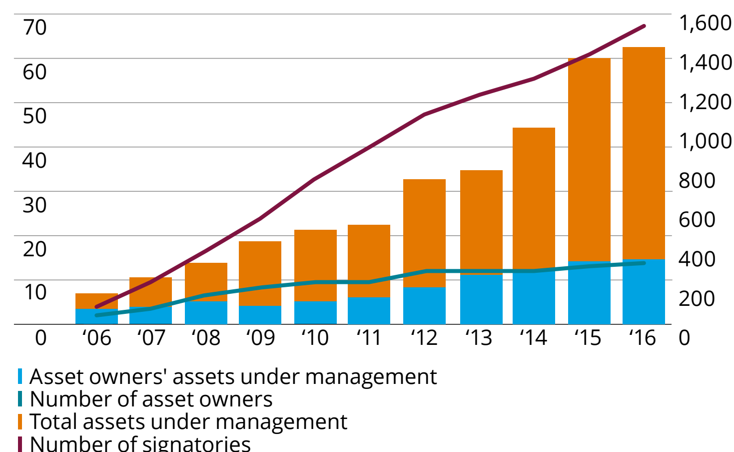
We now have a glimpse of the science behind the rise of ESG but, as with any scientific experiment worth its salt, we need to be able to measure a commitment to ESG, whether by an asset manager or by an individual company or within a portfolio. There are many ways to go about it, some qualitative and others more quantitative.

One way asset managers are providing tangible evidence of their adherence to ESG principles is to become a signatory of the United Nations Principles for Responsible Investing, or PRI. The PRI contain six initiatives:

- Incorporating ESG issues into investment analysis and decision-making;
- Being active owners and incorporating ESG issues into ownership policies and practices
- Seeking appropriate disclosure on ESG issues from those in which they invest;
- Promoting acceptance and implementation of the PRI within the investment industry;
- Working to collectively enhance to the effectiveness of implementing the PRI; and
- Reporting activities and progress towards implementing the PRI.

The PRI continues to promote ESG investing worldwide. It is currently working to establish guidance for ESG investing within alternative investments and is working with the CFA Institute on a study of investor attitudes toward ESG.

Adoption of the PRI continues to grow



Source: PRI Brochure, 2016. For illustrative purposes only.

Additionally, companies such as Bloomberg, Dow Jones, FTSE Russell, MSCI and Thomson Reuters have developed indices to help investors determine whether or not their portfolio holdings rank highly with regard to ESG concerns. Each index has different factors and ranking methodologies for including or excluding companies, but most focus on environmental stewardship and the promotion of good corporate governance and fair labor practices. While it can be helpful for investors to consult a benchmark as a comparison, indices of this nature are more closely related to SRI than ESG, as they consist of specific criteria that must be met in order to be part of the index.

Alternately, some companies have begun publishing sustainability ratings to help investors measure the relative success of their ESG strategies against a benchmark with similar objectives. For example, Morningstar has partnered with Sustainalytics to produce sustainability scores for mutual funds and other investment vehicles that focus on aspects of stewardship. However, similar to “ESG” indices, they lean heavily on certain required criteria, and are a better fit with SRI rather than ESG investing.

> Investors should consider that a qualitative approach, rather than indexes and ratings, should result in the most thorough assessment.

While we acknowledge that benchmarks and ratings can be helpful as a starting point for discussions around ESG issues within the investment market, the scores themselves must be viewed in the proper context. Each provider will have its own definition of stewardship or ESG, and comparisons across these measurements may not be appropriate. Investors must clearly understand the methodologies behind these comparisons so that results aren't misinterpreted. Other potential concerns include:

ESG aggregation difficulties: ESG concerns are complex, encompassing a large number of important issues such as supply chain management, carbon emissions and data security, to name just a few. Rather than fitting neatly into an "E" or an "S" box, most topics span the ESG spectrum. Efforts to quantify all these multifaceted issues under one score are understandably desirable but are ultimately imperfect and inconsistent. And definitions continue to differ across the industry whether they are from investment houses or third-party research providers.

Misinterpretation and differing fund rating approaches: Metrics used to calculate fund scores can measure the exposure to prominent ESG issues through assessing the underlying holdings, but the summation of these scores do not necessarily reflect a fund's strategy or intention. For instance, a fund manager that emphasizes engagement with a company to address key ESG risks may be unfairly penalized in the scoring process. Contrasting approaches and methodologies can also reach vastly differing conclusions. Becoming familiar with the underlying methods used for the ratings can help investors better appreciate the value of the fund scores.

Fund coverage thresholds: Coverage of fund holdings only requires a proportion of the fund holdings to have an individual score in order to assign an overall fund ESG score. Typically the threshold for this is around 50%-60% of a portfolio's assets under management, or AUM. This means you can have a scenario where a fund with just over half of its holdings scored is being compared with a fund that has had all of its holdings scored. Additionally, this threshold doesn't account for the weighting of the security within the portfolio. This provides inevitable complications when it comes to scoring methodology.

Subjectivity of assessing controversies: For Morningstar, a company's "controversy score" is taken into account when calculating the overall portfolio score. Likewise, a separate portfolio controversy score is applied to the fund. However, there is a great deal of subjectivity executed by the researcher to determine which controversies are counted as impactful and what level of risk they carry.

Variability of ESG metrics used by companies: The lack of uniformity in global ESG reporting means that there are inevitable differences in the metrics that are reported by companies around the world. This leads to inconsistencies in disclosure and difficulties in comparison.

Finally, investors should consider that a qualitative approach, rather than indexes and ratings, should result in the most thorough assessment. Investors can also obtain in-depth knowledge by reading companies' reports, which often address ESG risks and opportunities. Engagement with the management team of a company or asset manager before making an investment is even more effective, as this should result in a more detailed account of efforts to mitigate ESG risks. Once an investment has been made, regular communication with asset managers and companies can encourage an ongoing journey towards more sustainable practices.

Chapter 7

Bold experiments: ESG in emerging markets

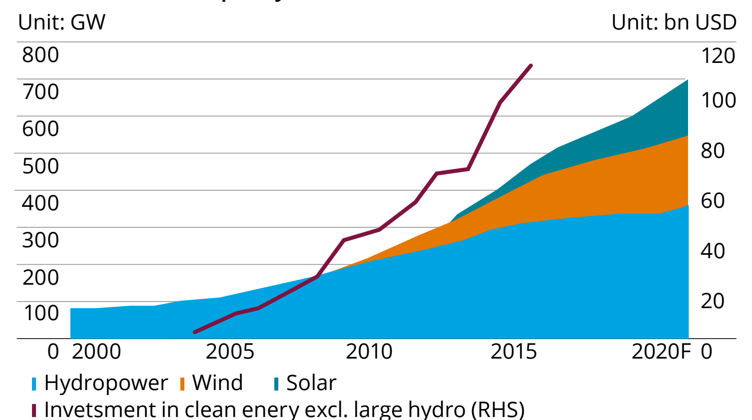
Emerging markets may not be the first place investors think of when they think about ESG. Many of the largest economies are often among the worst polluters of the environment, and corporate governance standards lag those of the developed world. But all of this is changing as emerging economies see a growing number of investors focused on ESG-related issues.

The increased demand for ESG investment solutions worldwide has spurred some of the largest emerging economies to begin addressing their ESG limitations. Nations like India and China are now looking to improve their environmental sustainability track records as reflected by their commitments to the objectives of the Paris Agreement. As emerging nations and their companies begin to improve their ESG credibility, there is great potential for new and exciting investment opportunities along the way.

China has made a significant push into renewable energy, creating millions of clean energy jobs and building solar and wind farms. The nation is ranked as the world's top job creator in renewable energy, and is responsible for the creation of two-thirds of the world's solar panels as well as half of the world's wind turbines. Additionally, China is the world's largest market for electric vehicles, and authorities are considering an eventual ban on the production of cars that use gas or diesel. Local manufacturers of rechargeable batteries are subsidized by the government in an effort for national brands to win out over foreign producers. While China still ranks as the world's worst polluter, the size and scale of the country's commitments to renewable energy show that there is still hope for a cleaner environment in future.

The increased demand for ESG investment solutions worldwide has spurred some of the largest emerging economies to begin addressing their ESG limitations.

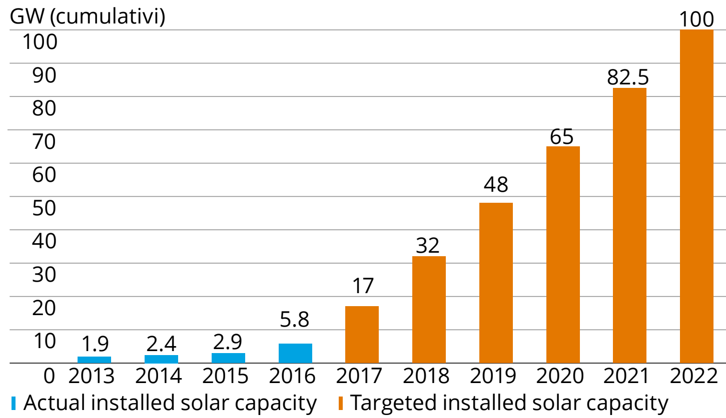
China's installed capacity of solar and wind, 2000-2020F



Source: China water risk based on CEC, NEA, BNEF. Projections are offered as opinion and are not reflective of potential performance. Projections are not guaranteed and actual events or results may differ materially. For illustrative purposes only.

Likewise, the use of fossil fuels in India is being reduced in favor of new investments in solar energy. Last year, the country unveiled what used to be the world's largest solar farm, and installed the fourth-most capacity for solar energy behind China, the U.S. and Japan. Additionally, there are plans for all 12 of India's domestic ports to be completely powered by solar and wind energy within the next few years. If this goal is achieved, India would be the first country in the world where all government-owned ports are run off renewable energy. Currently, the country ranks seventh in the world for solar energy capacity after being unranked even just a few years ago.

India's year-on-year solar energy targets



Notes: FY = All years in chart are fiscal year from April 1 to March 31; GW = 1,000 MW Sources: Bloomberg New Energy Finance (BNEF); The Economic Times; World Resources Institute, May 2016.
For illustrative purposes only.

Corporate governance is another area where emerging markets are beginning to make strides. Despite only slow progress thus far, higher governance standards should develop over time as money flows into these markets from international investors, particularly institutions, who have a definite objective of increasing ESG adherence within their portfolios. And as more companies are included in the MSCI Emerging Markets Index and other indexes focused on emerging markets, there will be even more demand for improvements in corporate governance in order to attract the interest of international investors. All of this bodes well for ESG investors looking at emerging markets for growth and diversification.

Chapter 8

Discovering more: ESG integration within actively managed strategies

Active managers have the freedom and flexibility to fully integrate ESG concepts within their investment strategies – helping investors achieve both their investment and stewardship objectives.

Many active managers have begun incorporating aspects of SRI into their investment processes. But this topic remains open to many interpretations, so it is vital for investors to become familiar with their asset managers' ideas about stewardship, ESG and the ways in which these ideas are woven into the management of their portfolios. These can range from following a set of top-down themes, to avoiding certain sectors or industries, to using ESG indexes or sustainability rankings for a quantitative measure of how the portfolio lives up to its supposed ideals. Each manager has its own philosophy on how best to evaluate these factors, and investors need to have a deep understanding of these methodologies in order to assess the potential impacts on their portfolios.

However, an integrated ESG approach, as opposed to a high-level stewardship framework, provides a different view. Rather than looking at third-party ratings or a loosely defined set of "moral" characteristics, true ESG investing involves an in-depth look into the inherent ESG risks and opportunities that may materially impact a company. It is a measure of an asset's true value as much as financial risk assessments would be. This type of ESG approach will require a team with extensive knowledge of these types of risks, as well as the resources to identify them and engage with companies on how they are being mitigated.

Evaluating ESG-related issues within an actively managed strategy has many potential benefits. Selecting holdings that have strong corporate governance evidenced by transparent reporting and conservative accounting procedures can lead to fewer corporate financial scandals and reduced portfolio risk. Being dedicated to supporting employees' well-being and adhering to fair labor practices can result in a happier and more productive workforce. And taking care to implement sustainable practices in order to protect the environment can improve brand perception, increase customer loyalty and guard against environmental catastrophes that not only damage communities and livelihoods but also have legal and reputational repercussions These benefits cross over into all types of investments, including both traditional and non-traditional asset classes.

- Holistic integration of ESG within the active management process typically involves the following steps:
- Understanding a company's material issues and risks
- Establishing holistic view of the strengths and weaknesses of a business
- Developing an accurate picture of the business in order to promote company engagement
- Recognizing risks that are most pressing to a particular business, determining their potential impacts on the portfolio, and discovering how these risks are being managed
- Fostering a productive relationship with a potential or current portfolio holding through continuous, in-depth engagement with company management

One of the most important responsibilities of an active manager is to conduct in-depth engagement with the companies in which the manager invests. Cultivating open communication with company management about certain risks and issues can help steer the company in the right direction, allowing the asset manager to play a vital role in promoting the very values they wish to encourage in their investments. And ongoing engagement can also help managers continuously evaluate which companies and management teams are of the highest quality.

Engagement should be ongoing, as it is critical to understanding a company's values and business model. Long-term investors need to feel comfortable engaging with company management in order to assess a company's ability to add value over an extended time horizon. Engagement can either alleviate managers' concerns or raise awareness about additional risks. Positive change in a company may take time and perseverance, but asset managers with a long-term focus need to be diligent about pursuing opportunities to make a positive impact on the companies they own.

While a holistic approach and ongoing engagement should allow an asset manager to gain unique insight into portfolio holdings, they aren't foolproof. The manager must also possess the research capabilities, intelligence and skill required to find potential opportunities for generating alpha. Investors should feel free to be inquisitive about the nature of a manager's implementation of ESG into their overall strategy and its role in generating portfolio returns.

One of the most important responsibilities of being an active manager is to conduct in-depth engagement with the companies in which the manager invests.

Chapter 9

Charging ahead: What does the future hold for ESG?

ESG investing has taken hold in the investing world, but for those who truly wish to make a difference in the world with their investments, there is still much more to accomplish. Here are some of the trends shaping the future of ESG:

- Increased transparency through reporting. Investors are increasingly expecting companies as well as asset managers to report on material factors relating to ESG. The current challenge is to present this information in a standard, comprehensive format. The Sustainability Accounting Standards Board (SASB) has helped issue guidelines on disclosing material risks and is fighting to include these disclosures on 10-K reports and filings related to initial public offerings (IPOs).
- More manager resources dedicated to ESG research. ESG investing is expected to continue to gain in popularity; therefore, managers who want to be seen as a prominent, knowledgeable voice on ESG factors will likely hire additional research professionals who specialize in responsible investing. We may even see the rise of ESG-specific investment credentials that represent an industry standard for ESG expertise.
- Expansion into alternative investments. While some alternative asset managers incorporate ESG concerns into their investing, this is likely to expand along with investor demand. Like managers of traditional assets, those managing alternatives will need to develop best practices centered on incorporating ESG into their overall investment processes. In this space, transparency may be more of a challenge since these are privately owned firms who aren't required to produce detailed reports about their strategies. However, an increased desire from investors to have a more complete understanding of how their portfolios promote ESG criteria may drive alternative managers to develop more reporting around these factors.

It's hard to deny the potential impact that an increased focus on ESG principles could have on investment strategies, business practices and the global corporate world if it continues to gain momentum. And this is only the beginning.

Similar to chemistry, there is still much to learn and much to discover in the world of ESG investing. Internationally, many companies and governments have stated a need for improvements in their stewardship of resources, whether natural, human or capital. Investors are driving this progress by placing their money with those they believe can help improve the world around them with innovative solutions to address the world's many environmental and social ills.

When the basic elements of ESG are identified and integrated into the investment process, investors and asset managers alike will be able to build on these principles with the goal of aligning return generation with stewardship. We can only imagine the possibilities ahead. From our perspective, the future certainly looks very bright.

Similar to chemistry, there is still much to learn and much to discover in the world of ESG investing.

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