The Role of Sustainable Investing

FIDUCIARY™ TRUST

Investment Strategy Insights

Successful investing in the service of our clients' best interests requires a disciplined approach that relies on proven investment techniques customized to individual client needs. Given the importance of environmental, social, and governance (ESG) factors in assessing the risk and return of an investment, we examine ESG factors in all of our investment-related decisions and offer a range of sustainable investing options to fit a variety of client preferences.

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The Growth of Sustainable Investing

A broad cross-section of investors is now embracing investments that seek to make positive environmental, social, and governance changes in addition to profits. These investors may be institutions or individuals, and they range from young to old and from the mass affluent to those with a high net worth. Total assets held in sustainable investments grew more than 54% to $35 trillion between 2016 and 2020, at a time when traditionally managed investments increased less than 7%.[1] This trend is likely to continue, as interest in sustainable strategies among high-net-worth investors grew in the aftermath of the health, economic, and social shocks triggered by the global pandemic.[2]

Exhibit A: What Is ESG?

ESG information is used to inform sustainable investment decisions

ENVIRONMENT
How a company performs as a steward of the environment

SOCIAL
How a company manages relationships with employees, suppliers, customers, and communities

GOVERNANCE
How effective a company's internal controls, conflict of interest guidelines, and other policies are, as well as the appropriateness of their executive compensation and board composition

It is important to note, however, that sustainable investing has been around for years. In fact, our firm has deployed some aspects of these strategies for two decades. If ESG factors are utilized in a balanced and structured way, they supplement fundamental analysis to help investors make better investment decisions.

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Utilizing ESG factors is consistent with being an active owner of capital, because ESG factors:

- Promote corporate accountability
- Expand decision-making information
- Increase attention on the long-term
- Incorporate the importance of ethical business practices

Our Sustainable Investing Approach

While the nomenclature has become more streamlined, the terms used to describe the ways in which investors can align their investments with their values has changed over the years. Today, the broadest term is "sustainable investing," which describes the entire spectrum of strategies that seek to make a positive impact in the workplace, the community, society, or the planet.

We offer four ways to engage within the sustainable investing framework:

- **ESG Integrated Portfolios** are diversified across asset classes and focused on investments and funds with high ESG ratings and proactive ESG strategies. They are designed for clients interested in pursuing a proactive ESG strategy while also achieving investment returns consistent with standard benchmarks. These portfolios span a range of risk profiles and have historically produced returns consistent with our standard portfolios.
- **Exclusionary Screening** allows investors to eliminate certain investments from consideration in their portfolios, such as companies that may be negatively impacting the environment or society. Depending upon their preferences, investors who do not want to invest in such companies can utilize these negative screens to avoid businesses involved in activities such as fossil fuels, tobacco, alcohol, firearms, and gambling.
- **Thematic Investing** enables investors to proactively support specific issues that are important to them while also generating investment returns. Investors seeking to make a positive change on a particular issue can choose thematic investing to create a strategy highlighting issues such as energy efficiency, clean water, or improving access to healthcare, educational opportunities, or housing.
- **Impact Investing** seeks to ensure that investment capital is not only aligned with the investor's values but is also producing tangible positive environmental or social impact. Examples of impact investments can include micro-financing to minority-owned small businesses or owning social impact bonds, where the return on investment will vary based on the achievement of an agreed-upon and measurable outcome.

How ESG Aligns With Our Principles

Given the potential for ESG factors to impact investment returns, we incorporate ESG factors in all our investment decisions. Our investment process is predicated on several core beliefs, and we believe sustainable investing fits neatly within these principles:

Managing Risks

A central tenet of our philosophy holds that investment success is not about what you make, but what you keep. This principle can be achieved through careful construction of a client's portfolio to maximize returns relative to the level of risk that is most appropriate for them, and ESG factors can play a meaningful role in managing that risk.

When it comes to risk management, the more data we can access, the better. While traditional analysis helps identify risks at an economic, industry, and company level, ESG factors can measure long-term risks associated with owning assets that may be vulnerable to climate change, for example. This is particularly useful in helping assess companies with long-lived assets, such as industrial and infrastructure companies, as well as long-term obligations, such as insurers and other financial institutions. The growing frequency of floods, droughts, and extreme weather associated with global warming is something that must be considered by insurers, utilities, real estate and logistics companies, and even tech and pharmaceutical manufacturers having physical plants in regions affected by storms.

By weighing such factors, companies can account for contingent liabilities, mitigating surprises owing to future asset impairments caused by environmental or governance issues. This is one reason why sustainable investments are often considered to produce more stable returns than non-ESG investments. In 2020, Morningstar analyzed funds across 19 different categories and found that those with an ESG mandate were not only less volatile than their category peers, they tended to lose less value than their peers during market declines over the past five years.[3]

ESG factors can play a meaningful role in managing risk

Prioritizing Financial Returns

During the early years of sustainable investing, there was a misconception that seeking to make a positive environmental or social impact required compromising on financial returns. Today, however, it is widely understood that ESG strategies do not necessarily require investors to sacrifice competitive returns. A meta study found that 90% of the more than 2,200 individual studies conducted on this subject found no negative relationship between sustainability goals and financial returns. In fact, the majority of this research — 63% — found a positive relationship between sustainable strategies and investor returns.[4]

Why might prioritizing environmental and social impact lead to better investment performance? There are several theories: first, environmental factors are, by definition, long-term considerations, as global warming risks unfold over the span of years, not quarters. As a result, managers and investors focusing on the "E" in ESG tend to be long-term minded. At the same time, companies that adhere to fair treatment of workers and customers — the "S" in ESG — are likely to experience lower employee turnover and greater productivity, potentially leading to greater operational efficiencies. And companies that focus on the "G," higher governance standards, are likely to embrace greater corporate accountability and transparency, reducing risks associated with unethical behavior or limited perspective.

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Providing a Custom Fit

We understand that clients come to us with unique needs, circumstances, and objectives and we strive to create fit-for-purpose solutions that reflect each client's distinct requirements. This includes finding the correct tradeoff between expected returns and risk through a customized allocation strategy that meets the particular client's needs.

Our client-specific process begins with the establishment of a personalized investment policy, which often incorporates inputs from a client's wealth plan. The personal values and sustainability goals with which clients want to align their investments can also be part of this customization. This is reflected in our Beacon.ESG portfolios, which are ESG-integrated strategies designed to reflect the investor's specific sustainability goals while achieving competitive returns.

Like our traditional Beacon portfolios, Beacon.ESG strategies utilize a mix of asset types — funds and individual securities, active and passive approaches, and public and private-market investments — to achieve a fully diversified client-specific portfolio. Our Beacon.ESG portfolios take an additional step by focusing on investments with strong ESG traits, rather than simply avoiding investments with weak sustainable attributes. Over time, the performance of our Beacon.ESG portfolios has been consistent with our traditional Beacon strategies.[5]

Moving Forward

Recognizing that clients have a variety of objectives and needs in pursuing an investment strategy, we offer a customized approach to constructing and managing a client's wealth. We embrace a similar philosophy when it comes to incorporating sustainable investing considerations into client strategies. This may involve mixing traditional and sustainable investment options or implementing different approaches to avoid certain securities or highlight impact-minded themes.

Regardless of the approach, incorporating ESG elements can improve the investment decision-making process by helping manage risks and can expand opportunities to bring about positive environmental, social, and financial outcomes. We stand ready to help you pursue a sustainable investing approach. ■

[1] Global Sustainable Investment Review 2020, Global Sustainable Investment Alliance.

[2] "Factset Measures COVID-19 Impact on High Net Worth Investors Globally," Factset.com, April 29, 2021.

[3] "Sustainable Funds Weather Downturns Better Than Peers," Morningstar.com, June 15, 2020.

[4] Gunnar Friede et al., "ESG and financial performance: Aggregated evidence from more than 2000 empirical studies," Journal of Sustainable Finance & Investment, October 2015, Volume 5, Number 4, pp. 210-33.

[5] Based on quarterly, total returns for FTC Beacon (standard) portfolios vs. FTC Beacon. ESG portfolios (Conservative, Moderate, Growth, and Aggressive Growth) for the period Q4 2019 through Q4 2021. The performance illustrated is hypothetical and does not reflect the performance of an actual portfolio or the trading of any specific investments. Performance is based on Beacon guidance which is calculated by using historical third-party manager and exchange-traded fund recommendations weighted to represent Fiduciary's tactical allocations within each Beacon and rebalanced annually. Rates of return are reported gross of Fiduciary's investment management fee, and net of transaction costs and fees charged by third-party managers. Past performance does not guarantee future results.