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Perspectives

A Guide to Sustainable Investing

Sustainable investing has grown in popularity in recent years. According to Morningstar, about $23 trillion in assets, globally, are invested in portfolios with sustainable mandates. That's a 600% increase from a decade ago. The increase coincides with a renewed passion from both institutional and individual investors to align their investments with their own personal views.

Types of Sustainable Funds

Sustainable investing exists in numerous forms and under various titles, but there are three main types of sustainable investment strategies employed today. Historically, sustainable investing focused on excluding certain investments, typically firms involved in alcohol, tobacco, firearms, and gambling. Those types of investment strategies are still very prominent and are frequently referred to as "values based."

A more recently developed (though still not the newest form) of sustainable investing focuses on positive rather than negative, or exclusionary, screens. This strategy emphasizes firms that are proactive on the tenets of environmental, social, and governmental (ESG) issues, often targeting firms, across all industries, that are relative leaders in this respect. These strategies are referred to as "Sustainable" or "ESG" investments. It's important to note that each E, S, and G factor can be defined differently from one provider to the next, making comparison across firms challenging.

The latest incarnation of sustainable funds has been dubbed "Impact Investing" and typically focuses on social and environmental impact, such as reduction in carbon footprint, energy or water saved, etc. This is the most difficult style to interpret and analyze due to short track records and limited transparency into the determination of these factors.

Fiduciary Rule Chatter

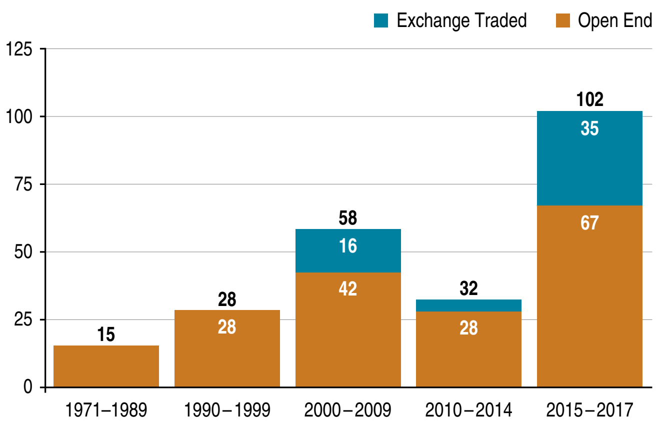
Sustainable investment options made headlines in early 2018 when the Department of Labor (DOL) issued revised ERISA guidance for plan sponsors on the use of these funds inside employee benefit plans. The DOL previously addressed this issue in 2015 noting that "plan fiduciaries are not permitted to sacrifice investment return or take additional investment risk" to "promote…social policy goals." Meaning ESG-focused investments cannot be utilized without appropriate consideration of risk and return—plan sponsors cannot simply choose a strategy because it focuses on ESG principles. At the same time, the DOL noted that social criteria could be used as a "tie breaker" for an investment choice.

That guidance was revised in 2016 to allow investment policy statements to "include policies concerning the use of ESG factors to evaluate investments" and noted that plan fiduciaries could integrate ESG metrics and analysis into risk and return evaluations. This revised guidance was largely interpreted as a positive sign for the future of ESG funds in retirement plans. Plan sponsors could seek out ESG-themed investment options and incorporate the evaluation of those factors into the analysis of investment options.

The latest guidance announced in 2018 made some changes to that language and placed an emphasis on returns and risk over social policy goals. It also noted that prudently selected ESG investment options can be added to plans if the addition of those funds does not result in the plan removing or forgoing the placement of non-ESG alternatives. It went on to state that, in the case of qualified default investment alternatives (QDIA), because the selection is not analogous to merely adding choices for plan participants, it would "not be prudent" to add an ESG-themed QDIA selection if other options have more attractive risk/reward characteristics. While the initial reaction to this change was somewhat negative on the future of ESG investing, the DOL noted that ESG-themed investment options can be added to retirement plans, provided the risk/reward characteristics are appropriate. The DOL has always made clear that as fiduciaries, plan sponsors are required to make decisions based on risk and return, among other issues. Adding a poor-performing ESG fund to a lineup would never be considered prudent nor would adding a poor-performing non-ESG fund. The focus on risk and return is (and should be) the same across all investment styles.

How to Analyze Sustainable Funds

Analyzing sustainable funds can be a challenge for a number of reasons. First, many ESG funds have very short track records. According to Morningstar, 102 sustainable funds launched between 2015 and 2017. This not a sufficient enough track record to evaluate a fund's team, process and philosophy, or performance. To circumvent this issue, a common practice among asset managers has been to co-opt a fund already in existence and change the mandate to include ESG criteria, giving the appearance of a longer track record.



Source: Morningstar Direct. Data as of 12/31/17.

Another challenge to analyze these funds is that there are no common criteria or rules defining exactly what "Environmental, Social, and Governance" factors actually mean. Each firm typically defines those criteria, implements the screening and analysis process around the criteria, and builds and monitors the portfolio differently. Some firms are more active, attempting to influence firms they believe are not meeting ESG standards to improve their practices, others simply vote proxies in a manner that aligns with their ESG principles.

Finally, while transparency among ESG funds is improving, there is still no common reporting criteria, much less a single regulatory source for vetting any reporting, for ESG funds in terms of outcome. Investors need to know whether the fund is successful in its mission, be it to lower carbon emissions, to avoid certain industries or types of firms, or encourage better compliance with E, S, and G tenets among its portfolio companies.

The best advice for practitioners is to follow the same investment analysis process utilized for non-ESG investments (including but not limited to a long tenured and experienced management team, a well-thought out and repeatable process, a long track record with an attractive risk/reward profile, and reasonable fees), adding additional analysis around the specific ESG goals and desired outcomes laid out by the management team.

About Mesirow Financial

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To learn how Mesirow can help you,
please contact Cara Esser at 312.595.8458
or cesser@mesirowfinancial.com.

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