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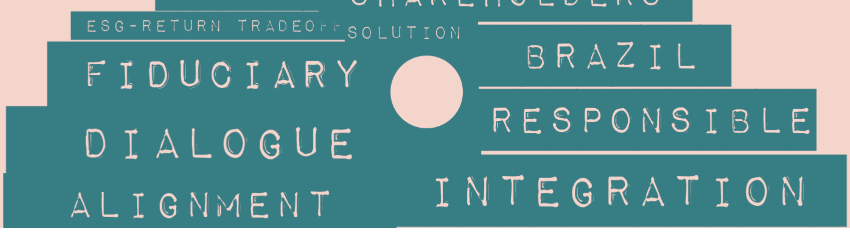

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ESG SHARPENS ITS EDGE

Investing that's focused on environmental, social and governance factors is now mainstream, driven in part by broad acceptance of the United Nations Principles for Responsible Investment, better known as the U.N. PRI.

Institutional investors are increasingly asking asset managers about how they are incorporating ESG factors into their investment processes. Managers have responded by providing reams of research on the efficacy of ESG investing, the ability to use these factors across asset classes and the importance of engagement.

But with so much focus and noise, has ESG become simply a virtue-signaling exercise, a corporate and investor equivalent of going gluten free? Has it lost its edge? In other words, has ESG become 'green' wallpaper?

"It's the opposite," argued Patrick McDonough, principal and portfolio manager at QMA. He noted that inflows to ESG remain small, and the very definition of ESG is still in flux.

"What's changed is that people are much smarter about how they want to implement their ESG," he said. "They are balancing their fiduciary duties with the benefits of being ESG-aware."

Advances in investment techniques have made the balance between ESG and returns easier than ever for investors.

"Investing in ESG has ceased to be a binary question," said Andy Howard, head of sustainable research at Schroders. Schroders is focused on integrating ESG factors into an investment process across its global business to provide a deeper understanding of a company's risks and exposures. It has invested heavily in building the tools and teams to achieve valuable insights that traditional approaches never could. As Howard put it, "ESG analysis is about examining different questions when considering companies, rather than applying someone else's answers to someone else's questions."

"ESG isn't window dressing if you do what we do. It's part of our core investment process," said Marshall Gordon, a senior research analyst for health care at ClearBridge Investments. In this case, ESG isn't an overlay or a separate practice. Instead it is embedded in fundamental analysis. His colleague, Deepon Nag, a senior research analyst for technology hardware at ClearBridge, added, "In 10 years, if you're a fundamental investor and you are not looking at ESG as part of your toolbox, you are not going to be an effective investor."

ALIGNING VALUES

What's also new is the rise of index-type ESG products that allow institutional investors to cheaply and efficiently obtain exposure to ESG factors. These indexes, even if they involve the exclusion of companies, can still offer a risk and return profile similar to the larger market. Reid Steadman, managing director and global head of ESG at S&P Dow Jones Indices, said, "They align institutional values with the values reflected in their investments."

Engagement is what truly sets ESG apart, giving it an edge over more conventional investment practices. Engagement offers the opportunity not only to shape outcomes, but also to deeply understand the risks at a company level that are overlooked by conventional analysis. (See Engagement: Success Stories on page 6)

The biggest change in ESG today compared with the past is better data. Advances in data have sharpened ESG investment practices and have allowed managers to more precisely build portfolios and better understand the risks and rewards of specific investments.

ESG MOVES TO THE CORE

As ESG has become a more mainstream investment, it has moved to the core of investors' portfolios. Previously it had often been relegated to a satellite position, an individual sleeve of an asset allocation or a special bucket. Advances in product design by leading ESG managers have enabled this shift. Investments with ESG exposure can now replace traditional allocation, not merely by asset class, but also in terms of alpha or beta return expectations.

"Investors are looking at actually using ESG to manage the core of the portfolio," Steadman said. The S&P 500 ESG Index targets market beta, but with additional ESG exposure.

Alpha-oriented ESG products are also now considered core. According to McDonough, "QMA targets the same alpha in our ESG portfolio as in other core products." All feature similar risk control, portfolio diversification and tracking error targets. The main difference is the addition of ESG exposure to a core product, but at no additional cost.

"We can have significant positive exposure to ESG while keeping the exact same investment goals, which would match the client's fiduciary and ESG requirements," he said. "Traditionally, this has been shown as a risk/reward efficient frontier. Now we can do a similar exercise, but with investment return and ESG."

EVERY STRATEGY

For managers who take a fully integrated approach, the idea of a separate ESG allocation, whether core or satellite, is in many ways obsolete. ESG is part of the overall investment process for all funds, but clients can still consider "impact" if they want their ownership to advocate for specific change goals. Said Gordon, "At ClearBridge, our approach doesn't separate ESG from core investment. All of our primary strategies explicitly consider ESG as part of their investment criteria."

At Schroders, ESG and sustainability issues are systematically incorporated into investment processes. How companies adapt to social and environmental change on a bigger scale and at a faster pace than ever is important to every investment strategy. Schroders emphasizes making its investment strategies as robust as possible and providing choice and transparency to its clients, rather than seeing ESG as mattering only for a niche of its fund range. However, it still offers sustainable and impact funds for investors who want an explicit allocation to these categories. Schroders recently acquired a majority stake in impact-investment manager BlueOrchard. Sarah Bratton, Schroders' investment director of sustainability, said, "We take a very rigorous view of impact investing, so it's mainly done via private assets."

Products that integrate ESG factors now go well beyond equities and can be used to replace allocations in many other asset classes. "You can also apply ESG factors within fixed income, within real estate, within multi-asset, within private markets," said Amanda Young, global head of responsible investment at Aberdeen Standard Investments.

ESG integration is an input for these investments, with "sustainable" investment merely one type of output or fund strategy. Young added, "You can't have the same approach for every asset class, but you can have the same principles: that you are committed to ESG as part of an investment process and to being good stewards of your clients' money."

The main thrust for ESG is ongoing improvements in data, increased integration and offerings in new asset

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ENGAGEMENT: ESG SUCCESS STORIES

Investors have shown time and again that how they own companies and the way they interact with them is as important as which companies they select.

"Engagement gives us an opportunity — as long-term stewards of our clients' capital — to ensure that we're holding those companies to account," said Andy Howard, head of sustainable research at Schroders.

Engagement is about shareholders using their voice to push for changes that they expect will help make the companies they invest in stronger over the long term. It can include questioning how a company is planning for climate change, how it is managing labor standards in its supply chain, as well as its approach to corporate governance and compensation.

For Howard, there is no single answer as to how to do engagement. Engagement doesn't just have to involve a single company if there are industrywide risks. Sugar is an example.

"In 2015, we started looking at sugar. It was becoming clear from academic work that sugar was a more severe problem in terms of health than widely recognized," he explained. The risks, including potential regulatory responses, were underappreciated by the market, and often the companies themselves.

In response, Schroders created the "Sugar Roundtable," a consortium of investment peers and companies committed to building a better understanding of what risks companies face and promoting better disclosure.

"That was a collective engagement on a thematic topic," Howard said.

Scroders set up a similar engagement initiative for climate change. Sarah Bratton, investment director, sustainability, at Schroders said, "We had over 70 nonexecutive directors at major companies represented at the event we organized. We helped board members and management understand how they should be looking at and managing these long-term structural risks and/or opportunities."

Amanda Young, global head of responsible investment at Aberdeen Standard Investments, argued that there are reasons to engage with a company above and beyond good stewardship. Namely, the chance to learn new information. "Engagement can help you gain a better understanding of what is happening in terms of ESG trends," she said.

UNDERSTANDING IMPLICATIONS

Young cited plastic as a case study. Aberdeen Standard Investments researched which sectors and companies, and its own funds, had exposure. The firm was looking for companies either involved in plastic manufacture or use, including those for which single-use plastics was a significant part of their business, such as restaurants and fast-food chains. Young said it's important to understand the implications of these issues; for instance, replacing these plastics because of regulation could be costly.

Interestingly, the firm found that its U.S. high-yield bond strategy was particularly exposed to single-use plastics, because it owned securities from a concentration of U.S. companies involved in the plastics industry. In response, Young's team engaged with each of these companies.

"The amazing thing about speaking to companies is you get better insights that you can't get from an academic paper, [or a nongovernmental organization] or broker paper," she said.

With the high-yield strategy, Aberdeen Standard Investments altered the portfolio construction and tilted the weights to reduce exposure to the ESG risk of plastics. The more typical engagement process is not to sell a stock. Rather, Young said, "it's more a case of we meet with the company, we make some very specific asks and set very specific milestones." Young works with companies to improve their disclosures, remuneration policies, management processes, board structures and independence — whatever the particular ESG issue.

S&P Dow Jones Indices relies on the power of the market to effect change.

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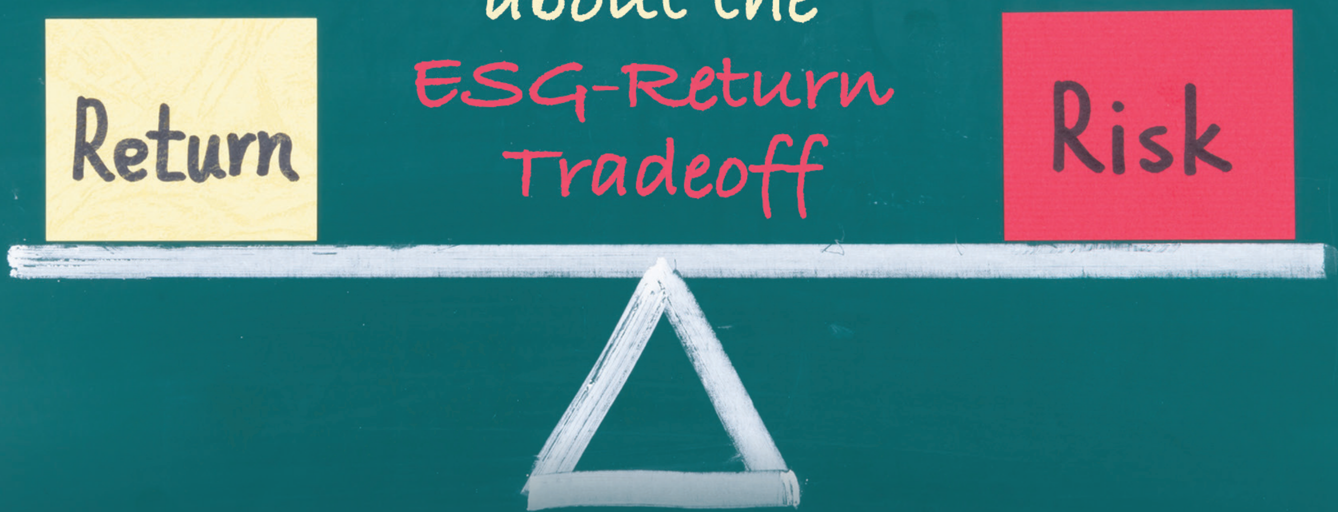
Conservation can create capital.

Fresh Thinking about the ESG-Return Tradeoff



As environmental, social and governance investing has evolved beyond simply excluding specific securities from portfolios — to avoid exposure to such factors as crude oil production, gambling, tobacco or alcohol — the relationship between investment returns and using ESG factors has led to more nuanced strategies.

"Trying to find ways to produce an ESG tilt without impacting performance is mathematically complex," said Patrick McDonough, principal and portfolio manager at QMA.

Indeed, for some investors, say a multigenerational family office, having a social impact may be the primary goal, not generating high returns. Often there are competing goals.

"Should ESG be material to the company we invest in or material to the world?" is a philosophical question posed by Deepon Nag, a senior research analyst for technology hardware at ClearBridge Investments. His answer, "It is material to both."

Today's leading ESG managers have resolved these issues by creating investment solutions in which there are no trade-offs between expected returns and environmental, social and governance factors. The investment techniques involved can target both beta and alpha.

"We've seen an evolution in how people think about ESG investing. Today, instead of seeking alpha, we see more interest in indices that have risk and return profiles similar to the parent index, but which provide characteristics and improvements from an ESG standpoint," said Reid Steadman, managing director and global head of ESG at S&P Dow Jones Indices.

For its ESG indexes, S&P DJI excludes companies with low ESG scores. Historically, using exclusionary methods could lead to returns that differ from beta or concentrated exposures or both. S&P DJI, however, has been able to create an ESG index that provides a "beta" return, very similar to the S&P 500, while excluding companies that are ESG laggards.

It is able to do this because even after making the ESG exclusions, the index — the S&P 500 ESG Index — still includes enough companies, sectors and industries that its composition is close to the parent index. It is market cap weighted too, just like the S&P 500. The result is an index that closely resembles the parent index, even if is composed of fewer companies.

"The aim of our methodology is to give you 75% of market cap coverage, industry group by [industry] group," Steadman said. "That ultimately will help drive a risk and return that is in line with the S&P 500."

NO TRADE-OFFS

Andy Howard, head of sustainable research at Schroders, said incorporating ESG into investment decisions should not lead to a trade-off between ESG and returns. "If you are doing ESG integration in way that leads to a cost, you are probably doing it wrong," he said.

At the same time, he argued, simply determining whether a company has positive or negative environmental characteristics is rarely an investment criteria in itself. But it is an important piece of information, particularly if these measures will be more highly valued in the future. "ESG is additive to the investment process," he said.

Howard framed an example to illustrate his point. Consider a company that has strong environmental credentials but is relatively overpriced by standard investment metrics and hence unattractive. Though the market isn't currently valuing these positives, going forward, with climate change and tougher regulations, the market value of the company might be much higher than today.

Assessing ESG factors may not pan out for every company, but paying attention to their potential long-term impact "is useful, valuable information to incorporate along with everything else you do," Howard said.

"Sometimes market sentiment seems to care about ESG factors, sometimes it doesn't," said McDonough. Underlying this viewpoint is QMA's quantitative research showing that the market value of ESG factors is neither repeatable nor predictable.

"Trying to time when ESG factors will matter is a fool's errand," he said. "We have not found ESG to be an alpha signal."

UNPREDICTABILITY

Further, price movements based on these sentiments are unpredictable and often counterintuitive, McDonough said, pointing to gun control as an example. If there were to be more regulatory pressure around guns, demand for firearms may increase, potentially lifting stock prices of gun manufacturers. Similarly, the share price of oil companies often increases after an oil spill, which appears counterintuitive.

"There can be very drastic price movements based on sentiment, but not in the way you would think, nor in a repeatable or predictable manner," McDonough said.

Given this unpredictability, QMA has found a risk-reward efficient frontier in terms of allocations toward ESG in a portfolio. "If you cross a specific threshold, you're going to impact the portfolio more, and you will start to have performance deviation," he said, adding that managers need to be open with asset owners about what level of comfort — or discomfort — they're willing to absorb along the ESG spectrum, including the performance risk that can hit the portfolio.

ClearBridge, a fundamental active investor, takes a very different view. Here ESG integration and engagement — and having decades of experience to extract value from both — eliminates the need for a choice between ESG and returns.

"ESG helps you avoid many risks and it enhances the strategic and actionable discussion that you have with companies, but it in no way detracts from returns," said Marshall Gordon, a senior research analyst for health care at ClearBridge Investments, pointing out that institutional investors' fiduciary responsibility means focusing on return. In ClearBridge's case, they don't have to choose because the manager pursues an integrated approach to ESG: "When we make an investment decision we consider both traditional business financial metrics as well as the relevant ESG issues; the two aren't separated." In addition, direct engagement and ongoing dialogue can further a company's progress along the ESG spectrum.

ClearBridge's sector-based approach is important here. ESG investors typically want to exclude entire industries — such as mining, oil and gas, defense, tobacco and other sin stocks — but by doing so, they may in fact give up returns. Rather than automatically excluding companies in industries or sectors with negative externalities, ClearBridge carefully examines how each company is dealing with its own ESG issues.

"We look at it through the lens of best practices in terms of ESG," said ClearBridge's Nag. "This approach improves returns and helps to align ESG outcomes with these returns."

LONG-TERM ASSESSMENT REQUIRED

In terms of ESG, the risk-return issue also depends on the asset class and the underlying investment.

"Applying an ESG lens in equities will be different from fixed income or real estate or private markets," said Amanda Young, global head of responsible investing at Aberdeen Standard Investments. Different asset classes typically involve distinct time horizons and liquidity profiles. For instance, in a fixed-income buy-and-hold mandate, investment managers need to incorporate a long-term assessment of ESG factors within their investment decisions. In other words, "Are the factors packed into the valuation of the company? Are they a big enough concern for us to actually discount our long-term view of the company's bond returns?" Young asked.

> Risk-return also depends on the asset class and the underlying investment.

From a liquidity standpoint, equities are easy to buy and sell, but long-term investors — like pension funds, endowments and foundations — can't ignore the potential long-term ESG risks. For example, consider integrated oil companies.

"In 10 years' time, fossil fuel assets might be stranded, because renewable energy becomes a lot cheaper and there is less demand for fossil fuels," said Eva Cairns, ESG investment analyst at Aberdeen Standard Investments.

When it comes to less-liquid asset classes, such as real estate, real assets and infrastructure, "the physical impact of climate change becomes an even more important consideration for investing, as more extreme weather events damage these assets," Cairns said. "Physical climate change impacts also affect agricultural outputs, which impact companies along the whole food value chain," she added. Asset owners should take notice. •

ACTIVE OR PASSIVE?

The debate over active versus passive money management is not relegated to traditional investment strategies. It is playing out in environmental, social and governance investing as well, where it is complicated by the fact that ESG can be active on multiple levels.

Even passive ESG investing involves the active choice of creating alternative indexes that incorporate ESG scores. ESG also typically involves engagement, which more closely resembles "activist" investing than active stock picking, a key distinction. Leading ESG managers now offer investment solutions along the full spectrum, from passive to active, and in between.

ClearBridge Investments, for instance, is an active manager and uses a fully integrated ESG approach.

"We are fundamental investors and ESG is a critical aspect of that," said Deepon Nag, a senior research analyst for technology hardware at ClearBridge. His firm uses ESG as a lens throughout its entire investment process. By contrast, other managers may have a specialist ESG team. Marshall Gordon, a senior research analyst for health care at ClearBridge, added, "Active management has an edge in engaging with the companies because we have the relationships to be able to converse with management teams with the benefit of deep industry and company knowledge."

Engagement is a key aspect of active management for Aberdeen Standard Investments as well.

"Being an active owner of a company, we can speak to a company to get insight into where a company is going, even if data is limited," said Amanda Young, head of global ESG investment research at Aberdeen Standard Investments. Engagement can make a company's management more cognizant of the ESG risks it might be facing, leading to a more "sustainable" business in every sense of the word. But engagement doesn't always work. Young said, "If a company still fails to listen, despite persistent engagement, as an active investor in equities, we always have the ability just to sell out."

WITH ESG, IT CAN BE A LITTLE OF BOTH

Schroders, another predominantly active manager, plans to have ESG factors systematically integrated into decision-making across all investment desks by 2020. "We're doing this [with] the expectation [that it] will help us deliver better risk-adjusted returns and provide a different perspective on companies we are investing in," said Andy Howard, head of sustainable research at Schroders. ESG is rarely the sole basis for an investment decision by Schroders, instead it is used along with other aspects of perfomance to form a more complete view of a company.

For Howard, ESG analysis is about asking how the value of an asset is impacted by social or environmental change. He wondered whether an index-based passive approach could be similarly valuable to investors. "It's difficult to see how an index would be useful in terms of what it delivers to clients," he said.

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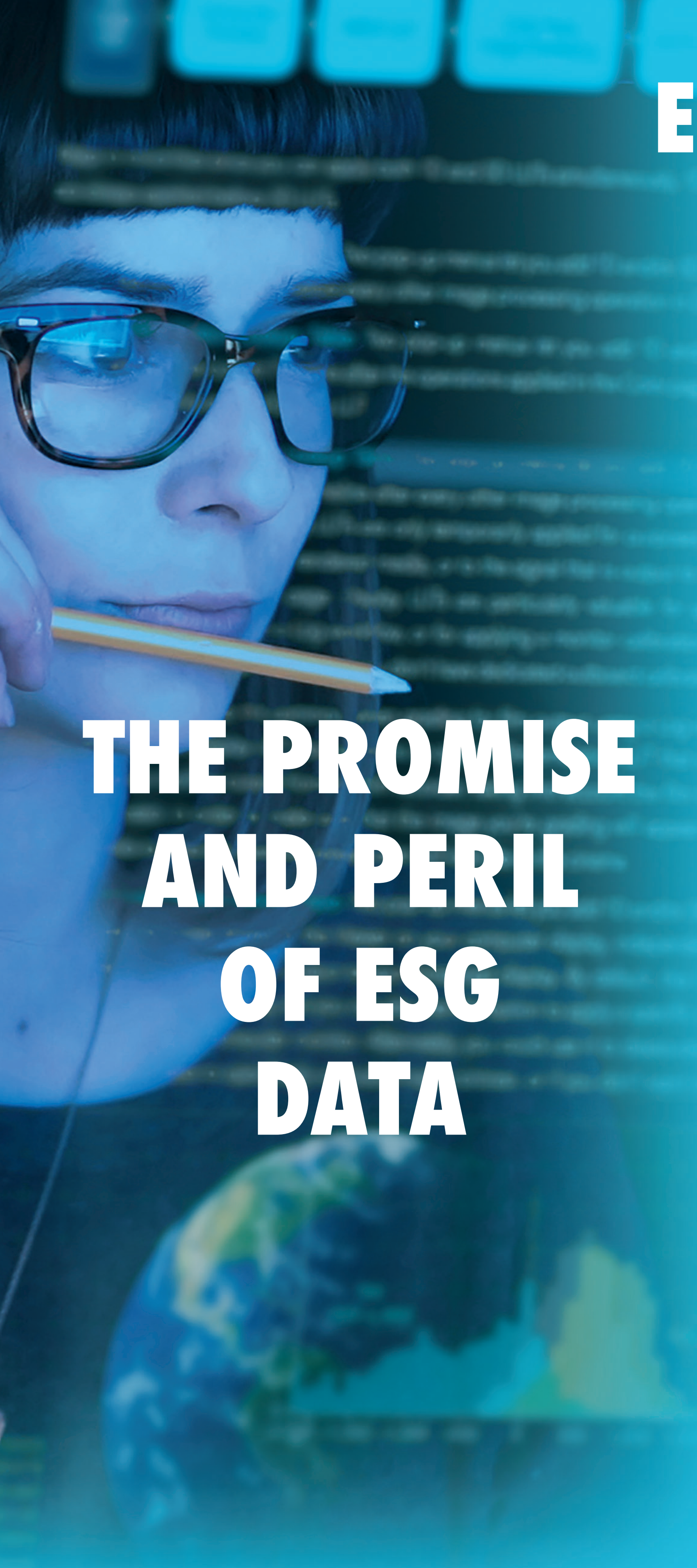

THE PROMISE AND PERIL OF ESG DATA

Environmental, social and governance data, once scant, has become a veritable flood. Investors risk drowning it.

More data might be considered beneficial to institutional investors, but the problem is that there are inconsistencies and vulnerabilities in it. For example, large companies are much better at disclosures than small companies, even if their underlying green credentials could be worse, a type of green washing.

In response, leading ESG managers have turned to a variety of new tools and techniques for analyzing data. These tools correct for existing biases and provide new sources of information. Even though ESG data is still far from perfect, ESG investing today rests on a more solid — and measurable — foundation.

"Current ESG data is amazing because it provides you with the ability to assess factors at a very broad level," said Amanda Young, global head of responsible investment at Aberdeen Standard Investments. At the same time, she is quick to point out there are still challenges. "Data is backward-looking and based on publicly disclosed information," she said.

New-data solutions offer a way forward. These include big data, automated data, nontraditional data and artificial intelligence, or AI. All the new data is a useful filter, but Young said a bottom-up analysis of a company and how it manages its ESG risks remain essential.

Using this approach, Aberdeen Standard Investments determines whether a company has adopted an ESG policy, and whether there are mechanisms for implementing it and reporting on its targets.

"The analysis is much more complex now than it used to be, but we're able to do more because we have data," Young said.

Climate change, one major ESG focus of investors, suffers from data gaps.

"Data disclosure around simply even carbon emissions can still be an issue," said Eva Cairns, ESG investment analyst at Aberdeen Standard Investments, who pointed to the United Nation's Task Force on Climate-Related Financial Disclosures (TCFD) as providing a framework for standardizing disclosures. Aberdeen Standard Investments supports the TCFD.

"TCFD is starting to become an international standard and offers a more forward-looking view of how companies are managing their role in the energy transition," Cairns said.

For S&P Dow Jones Indices, the "materiality" of ESG data is what is key. Reid Steadman, managing director and global head of ESG at S&P DJI, explained that financially material issues "are those that are likely to occur and, when they do, have a significant financial impact."

S&P DJI's environmental, social and governance data comes in part from SAM, the data unit of RobecoSAM, the Swiss active manager that focuses solely on sustainable investing.

"This ESG data comes out of a real investment process used to understand how ESG factors impact performance of companies," Steadman said. This is important, he argued, because much of the data used in ESG comes out of academic, theoretical exercises rather than real-world investment situations. S&P DJI also works with its internal partner, Trucost, a recent acquisition, to directly engage with companies to confirm that their data is accurate.

"We collect and verify our ESG data through direct engagement with companies, both through SAM and Trucost," he said.

Andy Howard, head of sustainable research at Schroders, said, "When I started in this area 12 years ago, there was very little ESG information available about companies. That situation is entirely turned on its head today." The number of sustainability reports produced globally has roughly tripled over the last five years or so, he said.

Schroders has developed a toolkit of over 10 proprietary investment tools and dashboards that focus on translating environmental or social trends into actionable investment implications. Factors have to be clearly evidenced to be included.

"The tools all are focused on one thing, the actual investment implications," said Sarah Bratton, investment director, sustainability, at Schroders. That means establishing insights into how companies' values will be affected. It also often means looking past the measures much of the market relies on. For instance, two companies may have the same carbon footprint but could face dramatically different exposures to climate risk.

Deepon Nag, a senior research analyst for technology hardware at ClearBridge Investments, a self-described "quant nerd," said ESG data suffers from "uneven disclosure, and until it is standardized, it is hard to assess who is best and worst in class." ClearBridge has found ways to correct for these deficiencies.

"We do not rely on third-party data and ESG evaluation. We are doing it on our own, and we come up with our criteria on a sector-by-sector basis," said Marshall Gordon, senior research analyst for health care at ClearBridge Investments. ClearBridge's integrated approach and focus on active engagement has led to the availability of and access to its proprietary data. Analysts who lead engagement have core relationships with companies' management teams and so can draw out new information.

USING RAW DATA

Unlike most ESG managers, QMA, doesn't rely upon engagement to obtain data points. "We don't feel like we're getting any new data we can't just get from scrubbing a website and reading a company's ESG policies," said Patrick McDonough, principal and portfolio manager at QMA.

Instead, QMA has partnered with third-party sources to obtain raw data. Even so, it has found problems with many of these vendors and approaches. Traditional ESG data can be highly inconsistent, QMA has found, with commercial vendors weighing scores differently. QMA therefore found it was most effective to turn to the Sustainability Accounting Standards Board, a nonprofit organization, for most of its data needs.

If there are any limits or holes in the raw data, QMA can rely upon its quantitative skills to fill in information gaps through sophisticated statistical modeling. In summary, McDonough said, "We partner with the right people to give us the right information and then use statistical 'stitching tools' to fill in any gaps." •

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classes and strategies beyond equities.

Clearbridge's Nag said, "I'm hopeful that environmental and social data will get better over time so we can actually start quantifying in a better way." His colleague Gordon added that in his view, how investors judge companies might change. Rather than just evaluating them on financial performance alone, how they impact society will also become widespread investment inputs. "It's been building over time, but it is becoming more and more important to consider how companies relate to society," he said.

The impact of tighter regulations on ESG outcomes and performance is another trend to watch.

McDonough pointed what he called a "massive shift" in regulations in Europe, where asset owners and managers now must consider ESG factors as they focus on their investment goals.

Changes in regulation could impact this disparity, with asset owners needing to spend more of their time thinking about ESG factors in addition to financial performance. "That's why we think our approach of blending the two is the next generation of investing," McDonough said.

Managers are also practicing what they preach. For instance, Steadman sees positive momentum toward companies operating in a more sustainable way and making decisions with a greater set of stakeholders in mind. "This is something that S&P Global is doing in terms of our inclusive hiring and trying to manage our emissions in a positive way," he said. He added, "It benefits individuals, it benefits communities and it benefits the environment."

Climate change might still be the biggest part of the ESG story. It is adding urgency to the discussions about ESG — it's not just far off in the future, but today.

Eva Cairns, ESG investment analyst at Aberdeen Standard Investments, said, "Climate change is an absolutely critical risk for the investment case today. It is not a longer-term issue." The extreme summer heat waves in Europe and the U.S. this year have made this issue more immediate. Cairns, whose work is focused on climate change and its investment implications, argued that a company's exposure to climate change should be part of every investment decision.

There are obvious risks posed by global warming — coastal real estate and agriculture come to mind — but there are many opportunities in low-carbon for investors to consider as well. Cairns said, "Asset managers have a critical part to play in financing the energy transition."

And because awareness of problems like climate change is now global, interest in ESG investment solutions is spreading across the world.

"There is not [a request for proposal] that comes in that doesn't have ESG questions," said Bratton, who works in Schroders' New York office. She said demand for sustainable products is now growing among U.S. institutional investors, who are catching up with their European counterparts. •

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"Rather than proxy voting, our approach is to make ESG performance more transparent and to put into place conditions to drive a healthy market-driven competition," said Reid Steadman, managing director and global head of ESG at S&P DJI.

Last year, the firm worked with the Japan's Government Pension Investment Fund, the world's biggest pension fund, to create an index — S&P/JPX Carbon Efficient Index — that would incentivize companies to disclose their carbon emissions, eventually leading to change.

"We came up with a compelling methodology whereby if a company disclosed [its carbon emissions], it was rewarded by receiving a 10% increase in weighting in the index and therefore more investment from GPIF, which manages assets according to the index," Steadman explained. Companies took note and there was an increase in disclosures, particularly in Japan.

"The index led to healthy market-driven competition," he said, explaining that from the time the S&P/JPX Carbon Efficient Index launched in July 2018 to the time the index was rebalanced in March, the number of companies in Japan that disclosed their carbon emissions rose to 370 from 337.

"Companies were trying to do better and better from an emissions standpoint to attain a higher weight in the index," Steadman said.

Companies can also improve their standing in the index based on how their carbon emissions rate compared with their peers. Companies are placed into deciles and index weighting is added or subtracted based on the decile. A company will get progressively more weight in the index as it moves into higher deciles, and vice versa.

The approach to engagement that ClearBridge Investments takes depends on the sector, according to Deepon Nag, a senior research analyst at the firm. A case in point is technology, the sector Nag covers.

In that sector, semiconductor companies tend to use a lot of water and electricity in manufacturing. "We engaged a company called SanDisk, which we are a large shareholder in, over its water use," Nag said. In response, the company created efficiencies in its water and electricity use, a positive change for both the environment and its business.

Health-care companies face a different set of ESG challenges. Marshall Gordon, a senior research analyst covering the health-care sector at ClearBridge Investments, said, "When I make an investment decision, I look at traditional criteria but also at how the companies are dealing with ESG-type issues." Here the specific ESG concerns can include whether innovations are positively impacting human health on an individual and collective level, and if patients can affordably access the treatments they need.

Because ClearBridge is well known for its ESG integration and engagement, some companies have sought input from the manager. According to Gordon, a biotechnology company transitioning from research and development of new medicines to commercializing its first product approached ClearBridge about ESG issues.

"They said, 'We realize we're becoming a bigger, more sophisticated organization, and we want your advice about what we could and should be doing from an ESG perspective,'" he said. The company already had adeptly managed a leadership transition and created a diverse workplace. ClearBridge's input in this case was to help the company inform investors about the good work they were doing.

A DIFFERENT VIEW

Despite these striking successes, not every ESG manager is sold on the value of engagement.

"We advocate for greater disclosure of ESG data through our collective engagement and work with ESG organizations," said Patrick McDonough, principal and portfolio manager of QMA. "We also exercise our view through the proxy voting process." The underlying reason is that as quantitative investors, QMA doesn't traditionally engage with the management of companies directly, relying instead on hard numbers to make investment decisions.

Still, when it comes to ESG, McDonough said he wouldn't rule out direct engagement if it were shown to be a value-add. But for now, "it's not in our nature from an investment standpoint. We don't view ESG as a source of alpha, nor do we feel like we are getting new data from such interactions." Moreover, McDonough said, when QMA does talk to companies about ESG, "we find that we tend to get PR pieces, standardized company fliers that basically say, 'We love ESG and this is how we do it.'" •

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Index-based approaches to ESG have their proponents. "With ESG, using an index is better than active management in that it typically results in a product that has lower cost," said Reid Steadman, managing director and global head of ESG at S&P Dow Jones Indices. The challenge specific to an ESG index is that by its nature it involves excluding companies. This means it may take on a lot of tracking error relative to its benchmark, leading to greater risk. However, because of the way S&P DJI constructs its indexes, it has been able to target broad market beta similar to the S&P 500 benchmark.

THE COST FACTOR

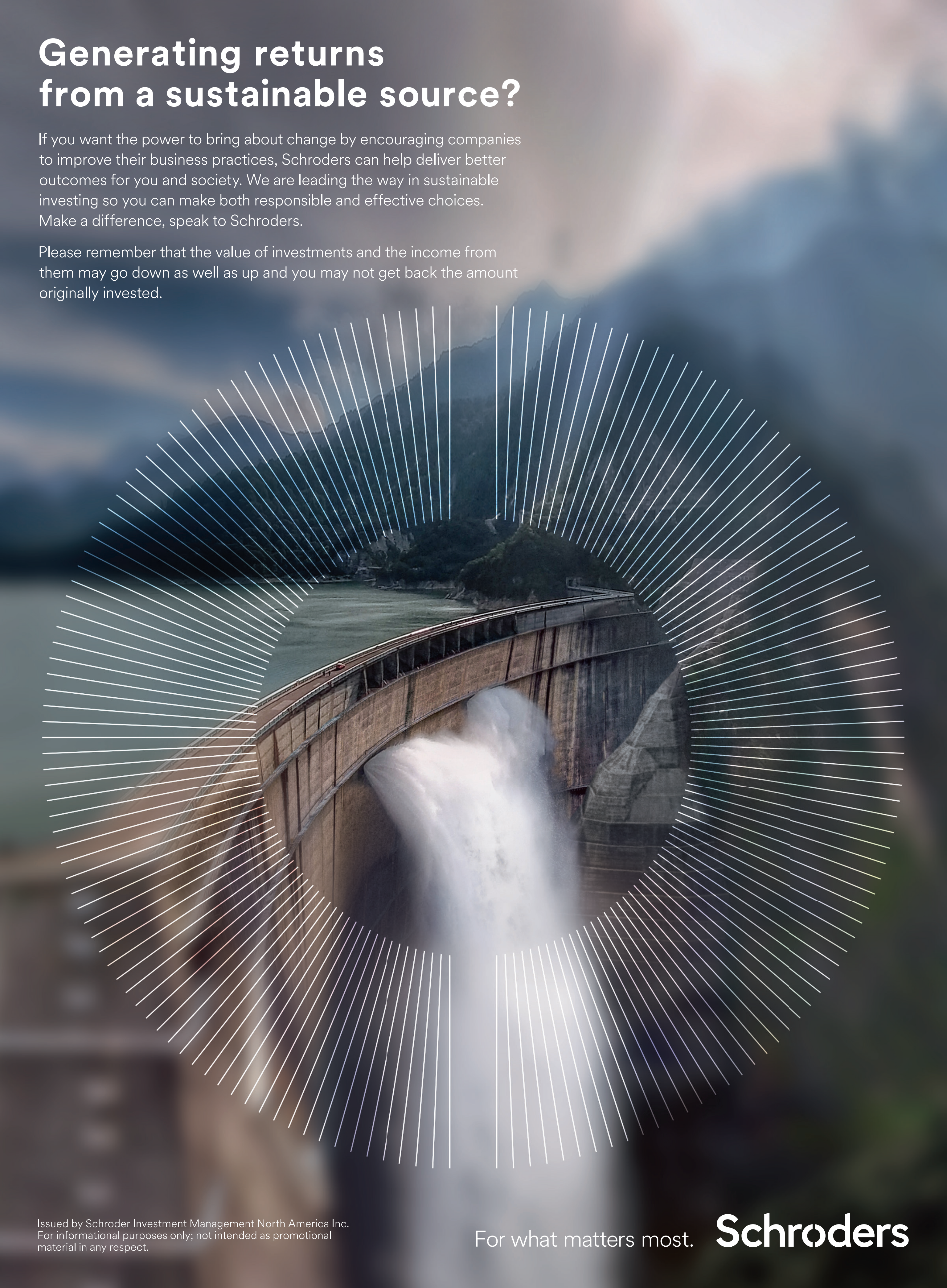
"ESG investors are likely better off investing in a low-cost product that tracks an ESG-oriented index, particularly if that index provides a return similar to the market," Steadman said.

One area of continuing debate is whether investing using ESG factors, including a passive index, can provide better risk-adjusted returns because ESG offers the potential to reduce or even eliminate exposure to certain risks. The possibility of outperformance compared with the standard benchmark is not a claim Steadman will make at this point. "That's something we continue to study, but we're approaching it very carefully," he said. What is indisputable, he said, is that S&P DJI's passive solution helps investors align their investments with their values.

The ESG marketplace also has hybrid solutions, which offer the potential for alpha-like returns through index-type investing. Patrick McDonough, principal and portfolio manager at QMA, noted that passive investing has become increasingly popular. However, many institutional investors are under pressure to beat their benchmark and to be more ESG-sensitive at the same time. To McDonough, that raises the question, "How can we bridge the gap between pure passive and not too-active active, and still have ESG be part of that conversation?"

Smart beta is one such a solution, because it involves investing around factors that produce alpha. But it is one McDonough avoids. Instead, QMA's core ESG solution targets the same alpha as QMA's other core products at no additional cost. McDonough said, "We think it's a better alternative than either pure passive or traditional active ESG products."

Aberdeen Standard Investments offers a range of strategies that integrate ESG factors — some index based, some traditional active — across many different asset classes. "We have developed ESG factor analysis for active quant positions with ESG tilts," Young said. •



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