

## **The Evolution of Socially Responsible Investment: From Values to Valuations**

**[HOST]:** Thank you for joining us for our podcast on the Evolution of Socially Responsible Investing or (SRI). With us today is Priya Khetarpal, Investment Product Manager for Social Investment Solutions at Northern Trust Global Investments.

This podcast will be helpful for institutions considering adding an SRI strategy to their foundation, endowment or defined contribution plan. We will cover the fundamental differences in philosophy, objective and investment process of each unique SRI strategy.

Priya, can you begin with a general market background describing the demand and drivers of growth for socially responsible investment strategies?

**[PRIYA]:** Thanks. Socially Responsible Investing is quickly gaining traction around the world. Today, \$2.29 trillion or 10% of assets under management in the U.S. are invested under SRI guidelines, according to the Social Investment Forum. This represents a 258% increase since 1995. In Europe, the SRI market accounts for €\$1 trillion, or up to 15% of European funds under management, according to a recent study by the European Social Investment Forum.

Drivers of growth come from all parts of the world and focus on the increasing relevance of environmental, social and governance or (ESG) issues as they affect both corporations and society. A key development has been the United Nations' Principles for Responsible Investment,

created to encourage incorporating ESG factors into investment decision-making and ownership practices. Dozens of institutional investors have signed on, including California Public Employees' Retirement System with \$210 billion US dollars in assets and Norwegian Government Pension Fund, with assets of more than \$250 billion US dollars.

Another critical factor driving SRI growth is the quantity and quality of SRI research. Until recently, only specialist firms provided this company research, which primarily consisted of identification of companies involved in controversial industries or activities. As sell-side research providers, such as Goldman Sachs, UBS and Citigroup, establish dedicated ESG research businesses, the next generation of research seeks to measure and quantify the effects of a company's management of ESG issues. As a result, investment approaches, and the very definition of SRI, are evolving to focus more on impact rather than involvement.

**[HOST]:** What exactly is socially responsible investing and is every institution implementing it in the same way?

**[PRIYA]:** In its earliest form, socially responsible investing was based on ethical beliefs and was primarily driven by mission-based institutions. Often referred to as first generation strategies, negative screens were used to restrict investment in "sin stocks" of firms involved in the manufacturing or distribution of alcohol, tobacco, adult entertainment, gambling and firearms.

Today's evolving approach to SRI is based on the belief that environmental, social and governance factors can impact the financial performance of companies. As a result, next generation strategies utilize more sophisticated research to select stocks based on optimizing both social and investment objectives.

For example, positive screening seeks to support and invest in companies whose social and environmental standards stand out among industry peers. Many institutions use positive screens to identify companies with competitive advantages, as there is a belief in the intangible benefit of managing social and environmental risks and opportunities. Positive screening also rewards companies that are making visible commitments to SRI principles, such as increasing levels of diversity in management positions or increased disclosure of environmental management policies.

Another second generation approach gaining momentum is shareholder advocacy. The primary elements of this approach include adopting SRI proxy voting guidelines, filing shareholder resolutions and engaging in dialogue with companies to promote social and environmental responsibility. These strategies aim to improve company policies and practices regarding stakeholder accountability while also promoting long-term shareholder value. Many investors consider shareholder advocacy an important part of any SRI implementation strategy because of the ability to make change.

Finally, third generation SRI strategies, such as ESG factor integration, have an explicit objective to use ESG factors to generate excess returns. While these strategies represent a minority of SRI

assets today, industry research establishes a growing consensus that corporate social performance can impact stock price.

According to Mercer Investment Consulting's survey of 183 investment managers, 75% of U.S. institutional investors recently polled believe that incorporating environmental, social or governance factors can be material to investment performance. And, 60% believe an SRI approach will reduce risk or improve returns.

**[HOST]:** So, how should institutions decide which strategy to use?

Selecting among the proliferation of SRI strategies requires a sophisticated understanding of the impact to expected risk and return. The effects of ESG factor integration will largely depend on the objective, philosophy and investment process of each unique SRI strategy. Important considerations include:

- Negative screens often create significant sector biases because of divestment of entire industries. Some second generation strategies address this by over and underweighting securities based on negative and positive screens.
- Second, ESG research providers use varying data sources such as public documents, media reports, NGO data or conversations with companies. This can result in significant differences in both positive and negative screens and therefore portfolio holdings.
- Third, the effectiveness of an SRI strategy will depend on the asset class. For example, shareholder advocacy cannot be implemented in a fixed income portfolio because there is no ownership.

- And finally, the investment strategy — including index, active and risk-controlled active — should be a component of product selection as it remains a significant determinant of excess returns.

The advent of second and third generation SRI strategies eliminates the tradeoff that investors previously had to make between investment objective and social mission. Negative screened products do offer simplicity and are widely available. But investors should take advantage of the recent proliferation of next generation products that enable SRI implementation throughout an asset allocation strategy. Building a fully integrated SRI strategy requires a detailed analysis of sources of ESG research, risk constraints, relevance of approach to an asset class, as well as other traditional metrics used to evaluate both passive and active investment strategies.

As analysts continue to build models to incorporate material ESG factors into valuations and alpha forecasts, the tradeoff between investment return and social return diminishes. The integration of ESG factors throughout the investment process represents the next generation of socially responsible investing.

**[HOST:]** Thank you, Priya for this thorough overview on Socially Responsible Investing.

**[PRIYA]:** My pleasure.

**[HOST:]** If you'd like additional information on SRI Investment Solutions please contact your relationship manager or Priya Khetarpal at 312-557-9038. To hear future podcasts from Northern Trust, please visit Northern Trust dot com slash podcasts to subscribe.

<Disclosure>

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