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Responsible Investment at BNY Mellon: Four Varieties of Environmental, Social and Governance-aware Investment Strategies

Institutional investors have a fiduciary responsibility to maximize return. Increasingly, they must also consider the social and environmental impacts of decisions made by the investment managers they hire. While some investors may view this as a dilemma that requires tradeoffs between investing for return and investing to advance specific environmental, social and governance (ESG) objectives, we believe a well-designed responsible investment strategy can help investors reconcile what otherwise may appear to be mutually exclusive goals.

Responsible investment strategies can be designed to meet a variety of investor objectives. They can give priority either to the pursuit of risk-adjusted return or social and environmental impacts, depending on the investors' objective. Investing approaches that integrate consideration of ESG factors can give investors an enhanced understanding of a sometimes overlooked source of portfolio risk as well as the means to improve risk-adjusted returns by identifying and addressing environmental, social, and governance risks. Other responsible investment approaches such as screening, tilts and impact/thematic investing provide additional ways for investors to align their investments with their personal or institutional values.

Why U.S. investor interest in ESG-aware investing is rising

U.S. institutional investors have been slower than their counterparts in other developed markets to adopt responsible investing. While most investors in Europe, Australia and Japan expect managers to demonstrate their ESG capabilities before entrusting them with funds to manage, many U.S. institutions have remained focused on more traditional understandings of risk and return that do not take ESG factors into account. One reason for the difference has been regulation. While most European governments encourage investment managers to consider ESG factors, U.S. retirement plan sponsors have

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interpreted the Employee Retirement Security Act of 1974 (ERISA) that governs the administration of their plans as prohibiting investment in strategies that pursue objectives other than maximizing investment return.

In October 2015, however, the U.S. Department of Labor clarified its position on responsible investing under ERISA saying, "fiduciaries may not accept lower expected returns or take on greater risks in order to secure collateral benefits, but may take such benefits into account as 'tiebreakers' when investments are otherwise equal with respect to their economic and financial characteristics." The DoL's statement at the time also said that "environmental, social, and governance factors may have a direct relationship to the economic and financial value of an investment. When they do, these factors are more than just tiebreakers, but rather are proper components of the fiduciary's analysis of the economic and financial merits of competing investment choices."

Responsible investment strategies target a range of impact and financial return objectives.

This regulatory rethink will likely give U.S. institutional investors more latitude to incorporate ESG factors into the management of their retirement plans without risk of breaching their fiduciary duty and it comes at an opportune time. Individual plan participants and other asset owners are increasingly aware of the social and environmental impacts that their portfolios can have, both positive and negative. Investors, like the population at large, are growing increasingly concerned about climate change as shifting weather patterns increasingly make themselves felt. The public sector has also begun to reflect a more expansive view of the objective of investing. Indeed, even as colleges and universities are under pressure to divest themselves of fossil fuel company stocks, some state and municipal governments are mandating that their pension funds' investment policies require consideration of ESG factors.

Demographics are playing a role in changing attitudes about responsible investment as family offices, endowments and public and corporate retirement plans alike increasingly come under the direction of a generation that views the relationship between investment and society as being more closely intertwined than their predecessors may have. The global financial crisis and high-profile events such as the 2010 Macondo oil spill in the Gulf of Mexico and Volkswagen's diesel emissions scandal have increased these investors' awareness that risk factors once considered irrelevant to companies' financial performance are important.

Several of BNY Mellon Investment Management's investment affiliates are signatories to the Principles for Responsible Investment (PRI), including Newton, Standish, Siguler Guff and Mellon Capital. The PRI is a global agreement which requires the managers who join under it to incorporate responsible investing approaches into their investment processes. PRI signatories must also issue regular reports on their investment activities regarding ESG issues. This requirement effectively compels them to identify and examine issues than most investment managers would also acknowledge are material, if they undertook similar research.

As changes in regulation dovetail with shifting global attitudes and investor expectations, the role played by ESG factors in investment decision making in the U.S. will increasing resemble that found in other developed markets.

How investment managers can practice ESG-aware investment

Responsible investment strategies target a range of impact and financial return objectives. Many target the same competitive rate of return as their conventional counterparts. Others may require an investor to accept a lower rate of return in exchange for pursuing a specific environmental or social goal.

Responsible investing approaches can be designed in accordance with either priority and they can be classified into four categories. The practice of identifying and incorporating ESG factors into investment decision-making is known as ESG integration and may benefit institutional investors by improving their risk-adjusted returns. Active ownership strategies take a step beyond integrating ESG analysis to use managers' rights as shareholders to press companies to adopt best practices regarding the ESG issues that the analysts have identified. Finally, screening or tilting approaches let managers align investors' portfolios with their values by either avoiding or emphasizing certain industries and sectors, while thematic or impact investing puts client assets to work by investing in assets, companies or projects that are meant to have positive and measurable environmental or social impacts as well as generate return. Both of these approaches may target competitive rates of return or require trade-offs in terms of investment performance.

Integrated environmental, social and governance (ESG) research may uncover ESG issues that can have a material impact on company value. Identifying ESG risks and opportunities ensure that challenges may be well managed.

ESG Integration and Equity Investing

Newton Investment Management, one of BNY Mellon's investment affiliates is a recognized leader in the investment approach known as ESG-integration. As long-term global investors, they manage institutional clients' assets with a focus on risk-adjusted return and seek to understand all the risks present in a portfolio in order to set return expectations. Newton's investment team views ESG issues as sources of potential investment risk and opportunity and believes further that fiduciary responsibility requires them to monitor and address ESG-related issues in their portfolios.

Newton has been engaged in responsible investment since the firm was founded in 1978. The firm's founders paid special attention to how the companies whose shares they held governed themselves, how they ran their businesses and whether they respected the interests of minority shareholders. Newton's concerns are the same today, and their understanding of risk and techniques for analyzing and managing it have grown increasingly sophisticated as regulation has increased and the investable universe has become a global one.

Responsible Investing

Screening/Tilting	ESG Integration	Impact Investing	Active Ownership
A filtering process that narrows the investment universe via exclusionary or best-in-class filters	A process that evaluates ESG risks and opportunities as part of financial analysis	Targets investments that generate a measurable social or environmental benefit alongside financial return	Influences company behavior through voting proxies, filing shareholder resolutions, and engaging in direct dialogue with company representatives
Excluding companies or sectors that are not aligned with your values or mission (fossil fuels, tobacco, weapons) or utilizing tilts to increase exposure to companies with superior return potential and positive ESG considerations	Investing in companies with strong Environmental, Social & Governance (ESG) performance along broad or narrow sustainability themes and integrating ESG factors into the investment process	Investing with the intention of targeting measurable impact outcomes and investment returns	A rigorous approach to corporate governance and proxy voting

To analyze and manage ESG-related risk across a wide variety of markets and regulatory regimes, Newton relies on a responsible investment team whose members are experts in environmental, social and governance issues in the same way that the firm's global sector or regional analysts are experts in energy or consumer goods or banking, for example. Unlike other managers who may outsource their ESG analysis to third parties, Newton prefers to keep this specialized expertise in house to increase their ability to develop a sophisticated and nuanced risk assessment process they believe will give the firm an investment edge.

Engagement is part of an investment approach known as active ownership, an ongoing process of using ownership rights including proxy voting to pressure the company's management to improve policies in areas where current company policy creates risk for investors.

How it works

Before any stock goes onto Newton's global recommended list, a formal ESG review known as an "ESG quality review" must be completed by the responsible investment research team. For example, if the firm's energy sector analysts wanted to recommend the stock of a large multinational energy company headquartered in a country whose government owns a controlling stake in it, they will first request an ESG quality review. Responsible investment analysts look to identify and quantify all of the material environmental, social and governance issues present in the company's structure, governance and operations. In this case, the state's equity ownership would raise concerns about corporate governance, particularly regarding the rights of minority shareholders and the potential for the government to use its ownership to control or influence management decisions in ways which could prioritize political objectives above business and financial ones.

Other factors that could come to light in the ESG quality review could include the potential liability for environmental damage resulting from the company's reliance on carbon-intensive methods for producing oil as well as the longer term possibility that the oil and gas fields it owns could become "stranded assets" made obsolete by decreasing demand as global energy markets shift away from fossil fuels.

Material ESG factor analysis enables Newton's portfolio managers to gain a more complete understanding of the risk/reward tradeoff involved in adding this position to a portfolio than analysis of the company's financial performance alone would provide.

While Newton's ESG analysts are members of the firm's investment teams, the decision to invest in or avoid a specific security rests with the firm's portfolio managers. When ESG analysts give low scores to a company, the investment team must consider those factors and have a robust discussion around risk-adjusted return potential before a portfolio fund manager is able to make a decision. In some instances, portfolio managers have taken the ESG analysts' advice and not invested in companies that later had scandals around the issues the analysts identified.

Putting ESG analysis to work: engagement and active ownership

Managers such as Newton who practice ESG integration also seek to identify opportunity and improve company practice through a process known as engagement. This involves the analysts approaching a company that the investment team is considering investing in, raising the ESG issues that they have identified and explaining why they believe the company's management should also be concerned. The analysts will explain to management any changes they would like to see made to company policy or process. Engagement is part of an investment approach known as active ownership, an ongoing process of using ownership rights including proxy voting to pressure the company's management to improve policies in areas where current company policy creates risk for investors.

If, for example, a manager practicing active ownership is unhappy about the lack of independence on a company's board, they could ask the company to put in independent directors. They might also engage on climate change with extractive companies to gain increased disclosure about the company's approach to stranded asset risk in their portfolios.

Engagement is a process that takes place over time and requires ongoing interaction between the manager and the company whose shares it holds. While the proxy voting rights of shareholders are important tools that managers can use to express views on issues of concern to responsible investors, the goal of engagement is to change company policy where necessary through active dialogue with management, not to cast dissenting votes as a way of expressing disapproval. If an engagement has been successful, the manager would likely have no need to vote against management.

ESG integration with active ownership is a form of ESG-aware investing known as ESG-momentum. Under the premise that companies with better ESG performance have better financial performance, companies with an improving outlook for ESG factors should outperform as investments. One way of looking at active ownership is as a mean of improving ESG momentum after investing in a company.

One type of thematic investing attracting significant attention from investors involves the reduction or removal of exposure to carbon-intensive industries from portfolios.

Other Approaches to ESG-Aware Investing: Impact or Thematic Strategies

For investors who may value social and environmental goals at least as much as investment return, some investment managers are exploring opportunities to go beyond ESG integration and bring impact and thematic investing strategies to market. These terms refer to investments that are meant to have a positive environmental or social impact. They may include "green" or "social impact" bonds aimed at, for example, improving a company's energy efficiency or reducing the rate of recidivism in prison populations. They may also include private equity investments meant to generate positive returns as well as measurable social or environmental impacts in areas as varied as healthcare, education, job creation and environmental remediation.

One type of thematic investing attracting significant attention from investors involves the reduction or removal of exposure to carbon-intensive industries from portfolios. Carbon emissions are easier to measure than many other ESG criteria and significant advances have been made recently in measuring the carbon footprints of corporations and in standardizing the measurement of emissions. Perhaps the best known is the CDP (formerly the Carbon Disclosure Project).

Each year, thousands of organizations report their carbon emissions, water management and climate change strategies through CDP. Similar disclosure and rating systems are being created for other types of ESG factors, such as The FTSE ESG Ratings which scores a large global universe of securities within the FTSE All-World Developed Index. The increased amount of reliable data may be raising investors' confidence that responsible investment strategies can impact and a growing number of foundations, universities and other institutional investors are interested in addressing environmental and social challenges within their investment portfolios.

How it works

The decision by a multi-billion dollar U.S.-based foundation, whose mission is to improve the quality of life for present and future generations, asked their long-time investment manager to design a strategy focused on climate change resulting from carbon emissions illustrates how thematic investing can work.

After initially considering divesting from oil and natural gas producers, the managers determined that the resulting volatility and potential for diminished return could constructively breach the manager's fiduciary duty to the foundation. Instead of running that risk, they pursued the goal of addressing rising carbon emissions and carbon dioxide concentration in the atmosphere by designing a thematic investment strategy that utilized engagement to drive changes in companies' policy from within and push for greater disclosure and clear plans to reduce emissions.

Exclusionary screens can be applied to a variety of types of investment vehicles.

To accomplish this, the investment team's researchers analyze the emissions, disclosures and any climate initiatives undertaken by each company whose securities they hold. They then practice engagement by using their proxy rights with those companies whose policies the analysts find wanting. The strategy seeks to achieve the foundation's investment and environmental goals by providing broad equity exposure while assessing, recognizing and supporting strong climate performance. The strategy's managers target a 50% or greater reduction in carbon emissions vs the benchmark and a tracking error of 50 basis points or less.

Historically, thematic or impact investing has posed challenges for institutional investors due to the relative scarcity of institutional-grade investment opportunities that meet the same kind of risk and reward criteria found in other types of investments. Self-defined impact investment funds that set out to achieve both impact and return objectives remain early in their development cycle and most may not have the scale necessary for institutional investors.

This may be changing, though. Some private equity managers recognize that the direct investments they have made in healthcare, education, financial inclusion and climate-related finance transactions based on their attractive risk and return profiles also deliver social and environmental benefits. These managers are developing strategies that seek to align financial returns with the social and environmental benefits created by those investments while also considering ESG risks. This area of impact investing may offer greater opportunities for institutional investors in the future.

Other approaches to ESG investing: screening and tilts

Years before ESG integration became an established investment process, the earliest forms of socially responsible investing employed negative screening in the portfolio construction process. Negative screening excludes investments that are incompatible with an investor's ethical values regarding, for example, alcohol, tobacco or firearms. Positive screening seeks to invest in enterprises that have, for example, best-in-class water use policies or progressive labor practices. Mission-based investors have long wanted their investment managers to exclude certain sectors from their portfolios, but an exclusionary approach can raise issues of fiduciary duty.

Screening has a long history, dating back to 18th century Methodist minsters who preached sermons on honest business practices and avoiding investment in socially harmful industries. More recently, religious organizations were among the first institutional investors to require their portfolios to avoid exposure to industries such as weapons, gambling or alcohol whose social impacts conflicted with the values of their faith. This approach remains popular today. For example, the U.S. Conference of Catholic Bishops (USCCB) and other religious organizations maintain published guidelines for managing investments in a manner that advances their church's values and principles. Many secular investors have also embraced screening approaches that reflect their own values and concerns.

Some screening strategies may not always require a complete ban on certain types of investment. Instead they may mandate, for example that a company's share of revenue from alcohol or gambling not be more than 10% for its stock or bonds to be considered for investment.

While the principle behind screening is the avoidance of undesirable or problematic investments, responsible investment strategies that utilize tilts seek to increase exposure to companies with superior return potential and positive ESG considerations. This may involve actively tilting towards companies that exhibit strong management and performance on environmental, social, and governance issues, while maintaining diversification across all industries.

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Conclusion

Regardless of the approach a manager takes to responsible investing, the momentum driving the mainstreaming of approaches that consider environmental, social and governance factors in investment decision-making appears unlikely to reverse. Fortunately for investors, investment managers are continuing to respond to that interest with ever-more sophisticated methods of understanding and addressing the relationship between investors' objectives and the world in which they live. The recent shift in U.S. regulations increases the opportunity institutional investors have to join in that process.

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