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SUSTAINABLE INVESTING AT AMG

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Sustainable investing allows investors to align their values with their investing.

INSIDE:

KEY POINTS:

- Sustainable investing allows investors to **align their values** with their investing.
- There are many ways to invest sustainably, and it's important for investors to understand the **options available** to them in order to achieve their goals.
- Sustainable investing is a growing area that should see **increased sophistication** over the coming years.
- Investors can utilize additional criteria when **assessing sustainable strategies** that, in conjunction with traditional investment manager research, can help investors achieve **financial returns while incorporating their values**.

EXECUTIVE SUMMARY

How do you employ your capital? Do you invest in equities and bonds, or donate to charities and philanthropic endeavors? Many investors do both to achieve two different goals: financial returns and giving back to their communities. For those investors, these two goals represent mutually exclusive uses of their capital. Sustainable investing is a growing type of investing that may offer certain investors the ability to invest with both goals in mind. Similar investing is sometimes called Socially Responsible Investing or ESG (Environmental, Social and Governance) Investing.

Sustainable investing is a way for investors to merge traditional financial investment goals with their personal values.

Sustainable investing is an umbrella term that covers a variety of ESG-focused uses such as:

- A way to screen out businesses that don't align with an investor's beliefs
- Finding companies that better align with an investor's goals
- Actively engaging with a company's owners to change business practices
- Honing into an area of ESG, such as clean water
- Directly investing in companies that attempt to make a positive impact

Investors interested in this approach have several questions to answer before choosing companies to invest in or choosing an investment strategy that takes ESG criteria into consideration.

- How do I want to generate financial returns and/or invest with my values in mind?
- What is the relative importance of these two goals in my portfolio and how do I balance them?
- What investments broadly fit my goals? Do they align with my values?
- How do I measure whether the investment is successfully meeting my expectations?

The right approach depends on the investor and his or her specific goals. This paper reviews different ways to sustainably invest, how investors may assess sustainable investing strategies, and some trends in the sustainable investing space.

WHAT IS SUSTAINABLE INVESTING?

Sustainable investing allows investors to generate financial returns, while considering their views on environmental impacts, positive social outcomes and responsible governance structures. Historically, sustainable investments focused on avoiding investing in companies that produce or sell "sin products" such as tobacco and liquor. More recently, some sustainable investment managers have started to seek out companies that positively align with the manager's investors' values. Sustainable investing has also tended to mirror the political and social climate of the time. For example, in the 1960s investors wanted to contribute to causes such as women's and civil rights as well as the anti-war movement. Today, there has been a growing trend toward investing in businesses that are environmentally responsible.

Assessing ESG criteria is subjective, so it is important that investors find investments that match their personal goals and values. Some investors' sustainably-oriented strategies may consider criteria that are not related to the financial performance of the investment, but rather allow for active engagement with ownership. For example, in 2007 shareholders submitted a proposal for the large financial services institution Wells Fargo to set greenhouse gas emission reduction goals. This would have a positive environmental impact, but the impact on Wells Fargo's financial success is less clear.

Yet, some ESG criteria have a measurable impact on the financial success of the company. For example, in 2010 British oil and gas company BP's oil spill in the Gulf Coast resulted in significant fines for the company. This had a strong impact on the company's environmental standing as well as their financial results. An investor with a sustainable focus could approach BP in several ways. If you are already an investor, you may choose to divest. Others may choose to invest at a reduced price and actively engage with ownership to try and change business practices. Still others may look to invest in other oil companies that have good track records on environmental safety.

These examples are not intended to dictate how an investor should behave in various situations, but rather to highlight the inherent subjectivity when assessing ESG-related criteria. Consideration of these types of factors in investing may or may not have a material impact on the financial results of the portfolio, but investors can still consider whether such factors align with their unique value sets.

THERE ARE MANY TYPES OF SUSTAINABLE INVESTING

Investors can think of using their capital along a spectrum, which is stylized as the Sustainability Spectrum in **Figure 1**. On one side of the Sustainability Spectrum are financially focused investments. On the other, are societally focused philanthropic endeavors, like donating to charity or issuing grants.

Figure 1: *SUSTAINABILITY SPECTRUM*

FINANCIALLY FOCUSED		← →		PHILANTHROPIC	
Traditional	**Integrated**	**Dual-Mandate**	**Engagement**	**Socially Focused**	**Charity**
ESG factors are not considered. This is potentially suboptimal, since certain ESG factors would have a material impact on a company's performance.	ESG factors are integrated into process to improve risk-adjusted returns. These strategies may still purchase poor performing ESG companies if other criteria are strong enough.	**Positive Screening** • Minimum acceptable ESG score for holdings. • Explicitly stated in prospectus that the fund considers some extra financial criteria. **Negative Screening** • Excludes certain companies based on ESG or broader values-based criteria, such as religious values or not wanting to own fossil fuel companies.	**Impact:** • Typically private capital investments that focus on a particular issue. • Often more measurable in its impact. **Thematic:** • Specific sustainability-related macroeconomic theme is stressed. **Activism** • Activist investing with a focus on improving a company's ESG profile.	**Program-Related Investment** • An investment focused on accomplishing one or more of the foundation's tax-exempt purposes. • Counts toward endowment distribution. • Expected to generate a below-market financial return. **Recoverable Grant** • A loan that may be converted to a grant, or a forgivable loan, that often promotes social impact over financial return. • Counts toward endowment distribution. • May generate a return of capital if successful.	**Donation** • No return of capital. • Purpose is for societal gain. • Goal is high-impact solution. **Grant** • Like a donation, but the organization must use it for a certain purpose.

Source: AMG

Sustainable investing introduces a few additional options outside of traditional investing and charitable donations. For example, many active managers today take an **integrated** approach to ESG factors, but only to improve risk-adjusted returns. These investment managers focus on ESG criteria that are material to risk, return or both.

One step closer to a societally focused strategy are **dual-mandate** approaches. These investment strategies take ESG criteria and traditional investing criteria and build both into their processes. However, these strategies often have minimum ESG criteria for a stock to enter their portfolio and occasionally use ESG criteria to help weight positions. They often consider ESG criteria that may be immaterial to financial risk or reward.

Farther to the right on this spectrum are **engagement-focused** investments, which are often found in private capital vehicles. These are often investments made in a specific theme or industry that the investor has a passion for, like solar power.

Rounding out the spectrum are traditional philanthropic endeavors, like **donations** to a dearly held charity or providing various forms of **grant** funds.

There are no one-size-fits-all solutions along this spectrum. It is purposely expansive given the wide range of investor preferences. This serves as a useful tool for categorizing investment strategies and helping to identify which approach makes the most sense in an investor's portfolio.

A FRAMEWORK FOR ASSESSING SUSTAINABLE INVESTMENTS

Assessing sustainable investments goes beyond the criteria used for traditional investments. (For a snapshot of some important areas to research with traditional investments, see **Figure 2** "Assessing Traditional Investments"). AMG expects its active managers to integrate any ESG criteria that may be material to financial returns into their investment processes, and generally consider the active managers as falling under the "Traditional" or "Integrated" areas of the Sustainability Spectrum.

For **Dual-mandate** or **Engagement** strategies, investors may add a four-step process on top of traditional investment research criteria:

Figure 2:
ASSESSING TRADITIONAL INVESTMENTS

Investors assess investment managers on many qualitative and quantitative criteria.

Stability and consistency must be reflected in the manager's:

- Investment philosophy and process
- Business model
- Historical performance
- Personnel

Further, high-quality investment managers typically show an ability to:

- Align interests with their investors
- Differentiate from their benchmarks
- Follow a disciplined, well-established approach

1. **Sustainability Categorization:** At this stage, where the strategy fits along the Sustainability Spectrum is defined. Many strategies have components from several categories. For example, an investment strategy may only invest in companies with strong ESG ratings based on proprietary research, while screening out any company that derives more than 10% of its revenue from fossil-fuel related activities. This would be a combination of positive and negative screening types of dual-mandate investing defined in the Sustainability Spectrum graphic. This may also include categorizing the strategy's approach to engagement with management and any thematic tilt the strategy might have. An example of a thematic tilt might be focusing on companies encouraging gender diversity, or companies focused on improving access to water.

2. **Sustainability Research:** For an investment strategy to deliver on the sustainability research mandate, a well-disciplined research process must be defined. Some key criteria to look for are experienced and well-tenured ESG analysts who look at both ESG and financial criteria, a long-standing commitment to incorporating ESG factors into the strategy and an ability to talk about the companies within the portfolio from an ESG perspective.

3. **Historical Sustainability Assessment:** Critically assessing how well the investment strategy has achieved its sustainability mandate is important. There is no straightforward answer to this assessment. While there are ESG ratings agencies that provide the average ESG score of companies within a portfolio (like credit ratings for bonds), these scores vary significantly from issuer to issuer. A holistic use of these ratings, discussions with the investment manager and reviews of the investment manager's reporting are all tools that can be used to get a comprehensive view of historic sustainability.

4. **Communication Framework:** Given the inherent subjectivity in sustainable investing and the lack of common metrics, frequent dialogue and reports from the investment manager are important tools in understanding how well the strategy is executing on its sustainability mandate. Transparency from the investment manager is needed to ensure that they are delivering on the dual-mandate consistently through time.

Figure 3: *ASSESSING SUSTAINABLE INVESTMENT PERFORMANCE*

While performance analysis is important for any investment strategy, there are additional considerations to be made when assessing those that are sustainably focused.

Sustainably focused strategies generally encompass constrained opportunity sets within a broader asset class, which causes these strategies to perform differently from that asset class. A sustainable investment strategy may focus on large cap domestic equities, but because certain industries are off limits, the S&P 500 may not be the best benchmark. Further, since the constraints on sustainable strategies vary widely, there are typically not indexes that fully reflect the strategy's opportunity set.

For performance analysis, it's important to understand what out or underperformance versus the benchmark is due to policy constraints (for example, not investing in companies with fossil fuel reserves) or active decisions designed to contribute to outperformance or reduce risk. Simply comparing performance against the benchmark and making a judgement call on the strategy will miss the bigger picture. This makes performance analysis more complex than with strategies only focused on outperforming a benchmark.

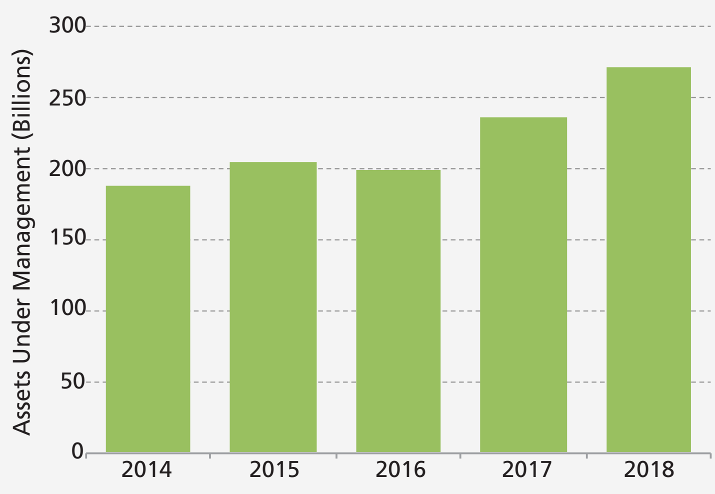
The bottom line is that a mosaic of several pieces of information, including an assessment against the benchmark and reviewing holdings to ensure the strategy is excluding the businesses it says it will, are important. Regular conversations with the portfolio managers on the strategies are also critical to understanding how the team is investing and whether that continues to align with the investor's values.

SUSTAINABLE INVESTING GOING FORWARD

Changing demographics and growing demand have fueled a rise in ESG investment opportunities. These developments in turn afford AMG a wider opportunity to identify compelling ESG-related strategies.

The sustainable investing industry is still young. While the U.S. Forum for Sustainable and Responsible Investment (SIF) estimates $8.7 trillion of professionally managed U.S. assets consider sustainability in some way,[1] Illustrated in **Figure 4**, only about $250 billion of that is invested in mutual funds or ETFs that are actively seeking businesses that align with ESG values (as opposed to simply screening out certain types of businesses from their investable universe).

Figure 4: *TOTAL SUSTAINABILITY AUM*



Source: AMG, Morningstar. Includes all mutual funds and ETFs flagged as "Socially Conscious" by Morningstar.

Should growth in this space continue at the pace set in the past couple of years, some positive developments may occur. First, companies may continue to focus more on ESG-related issues facing their businesses. Second, more sustainability focused strategies may launch, providing investors with more options. Finally, more standardized reporting in impact, both at a company level and an investment strategy level, may develop. This is important, as we can't improve what we can't measure.

[1] *www.ussif.org/files/SIF_Trends_16_Executive_Summary(1).pdf*

INCORPORATING SUSTAINABLE INVESTING INTO YOUR PORTFOLIO

This paper highlights some of the nuances behind investing sustainably. Investors who wish to incorporate sustainable investing in their portfolios will have to consider several key questions, including an assessment of their values, how best to balance financial return and social impact in a portfolio, and what investment strategy aligns with their goals.

There are no one-size-fits-all solutions for this style of investing. While there are some strategies that may appeal to a broad range of investors, your goals are unique to you. Understanding options in the space and how they relate to your own personal goals are two of the key starting points to integrating ESG investments into your portfolio.

AMG National Trust Bank

AMG is a privately held wealth management firm offering comprehensive financial services designed to help clients achieve long-term financial security and success. For over 40 years, AMG has helped affluent individuals and families, corporate executives, business owners, nonprofit institutions and endowments achieve their financial goals.