LPL RESEARCH
PRIVATE CLIENT
THOUGHT
LEADERSHIP

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Sustainable Investing

Strategic Discovery

LPL Financial

CONSIDER THE FOLLOWING

An energy company fails to uphold sound health and safety standards…	In 2010, while in the Gulf of Mexico, one of the company's oil rigs suffers a massive explosion. Shareholders lose 50% of their value in the following three months.
The Board of Directors of a telecommunications company does not enforce sound accounting practices…	In 2001, the company's internal audit department uncovers extensive fraudulent accounting practices that result in the company's bankruptcy, the largest in U.S. history at that time. Shareholders lose an estimated $180 billion.
A New Jersey based utility develops new technology that enables the company to efficiently service drought-stricken western states that previously were not cost-effective areas…	The technology enables growth that translates to a 242% increase in the company's stock price over the next eight and a half years, compared to a 60% increase in the S&P 500 Index and a 23% increase in the utilities sector over the same period.

These examples illustrate the impact of three corporate decisions that significantly affected shareholder value far beyond what was likely expected. However, despite their potential to drive performance, qualitative factors like safety standards, board oversight, and sustainability projects are often missed by investors and portfolio managers primarily focused on traditional financial metrics.

These particular issues are examples of environmental, social, and governance (ESG) factors. The deliberate practice of incorporating ESG factor analysis into traditional financial analysis is referred to as sustainable investing. Not all examples of ESG factors will be as significant as those above, but they may not need to be in order to have relevance. According to industry experts at the CFA Institute, "systematically considering ESG issues will likely lead to more complete analyses and better-informed investment decisions."[1]

1 CFA Institute, "Environmental, Social, and Governance Issues in Investing: A Guide for Investment Professionals," 2015.

SUSTAINABLE INVESTING

The idea of sustainable investing is not new, and many investors relate the term to socially responsible investing (SRI), which is an investment strategy that excludes companies and industries on a basis of moral values (e.g. alcohol consumption, gambling). This type of strategy still exists, but it is important to note that sustainable investing has evolved beyond emphasizing exclusionary screening based on a narrow range of criteria. Today, greater emphasis is placed on which companies to include, rather than exclude, from a portfolio, giving rise to a range of complementary approaches that can be used to implement sustainable investment strategies. The strategies are ordered by the level of intensity of the ESG factor consideration in the overall investment process.

EXCLUSIONARY SCREENING

Avoiding investments in companies or industries on the basis of moral values and standards (i.e., tobacco), and social norms (i.e., human rights), historically referred to as SRI

BEST-IN-CLASS SELECTION

Selecting securities based upon strong or improving ESG-factor issues relative to the company's industry peers

ACTIVE OWNERSHIP

Entering into a dialogue with the management teams of the portfolio holdings on ESG issues, and exercising ownership rights (i.e., voting proxies, submitting shareholding proposals) to promote change

THEMATIC INVESTING

Focusing investments on specific environmental or social themes, such as clean energy, water, education, or healthcare

IMPACT INVESTING

Selecting securities to promote social and environmental benefits in addition to earning a financial return

ESG INTEGRATION

Systematically integrating ESG considerations, where material, into investment due diligence and financial analysis

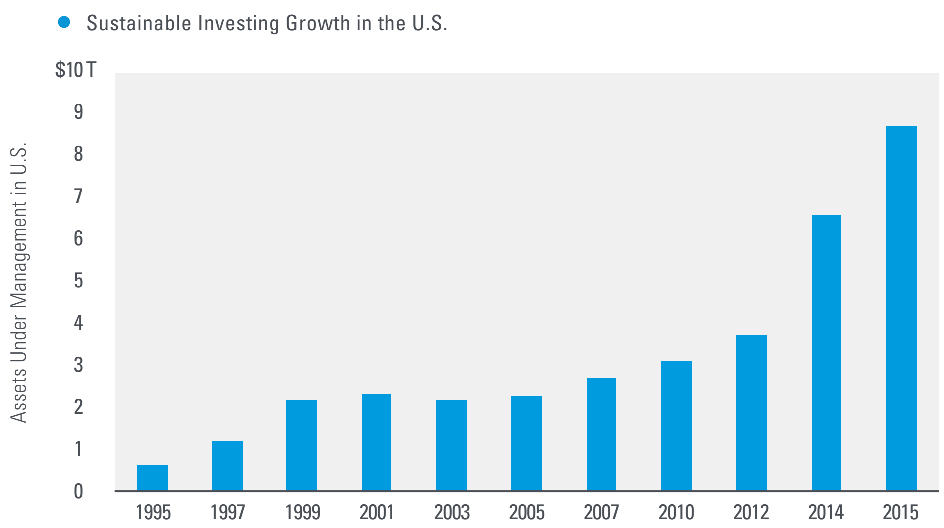
Source: LPL Research, CFA Institute, "Environmental, Social, and Governance Issues in Investing: A Guide for Investment Professionals," 2015.

GROWTH IN SUSTAINABLE INVESTING

Sustainable investing continues to gain steam globally, with assets under professional management increasing to $21.4 billion by 2015.[2] Although more than half of these assets are in Europe, sustainable investing has also grown tremendously in the United States in recent years, with assets under professional management increasing by roughly 133% since 2012. Total assets under management for sustainable investing in the U.S. reached a whopping $8.72 trillion in 2016—roughly one out of every five dollars under professional management [Figure 1].[3]

Many forces are driving this growth, including increased awareness that ESG factors have a positive impact on performance and changing demographics, as millennials consistently express greater desire for some sort of sustainable investing solution. Also at work are changing social norms and the political polarization in the country, leading some investors to see their social views represented in their portfolios.

1 SUSTAINABLE INVESTING DEMAND IN THE U.S. HAS RISEN SHARPLY IN THE LAST 5 YEARS



Source: LPL Research, US SIF Foundation, 2016

POSITIVE, MATERIAL IMPACT ON PERFORMANCE

Some investors and financial professionals are skeptical of sustainable investing because, intuitively, shrinking one's investable universe could make outperforming the market more difficult. However, researchers from the University of Oxford and Arabesque Partners aggregated the results of

2 Elizabeth Lewis, "Navigating the Sustainable Investing Landscape," World Resource Institute, December 2016.

3 US SIF Foundation, "Report of Sustainable and Responsible Investing Trends in the United States," 2016.

200 studies globally and reports on the impact of sustainability on corporate performance and found the following:

- 90% of the studies conducted showed that sound sustainability standards can lower a company's cost of capital, allowing these companies to grow with lower costs and greater potential shareholder returns.
- 88% of the research showed that solid ESG practices result in better operational performance.
- 80% of the studies showed that good ESG practices positively influence a company's stock price.

In other words, investors should not think of sustainable investing as shrinking the investment universe, but rather focusing on companies within that universe with the best prospects. One aspect of sustainable investing is that part of the investor base is actively encouraging companies to improve their ESG scores. To the extent this may result in better corporate governance, greater regulatory compliance and other positives, the benefits to a sustainable portfolio may be self-perpetuating.

One proxy commonly used to measure the performance of sustainable companies is the MSCI KLD 400 Social Index. This index is composed of firms in the U.S. with the highest ESG factor ratings relative to their industry peers, and it completely excludes companies in the alcohol, gambling, tobacco, weapons, and adult entertainment industries. Over the past 10 years, the MSCI KLD 400 Social Index has slightly outperformed the S&P 500 Index and has also done so with slightly lower volatility [Figure 2].

2 MSCI KLD 400 SOCIAL INDEX VS. S&P 500 INDEX (PERIOD: 01/01/08 – 8/31/18)

No Diminution of Performance Using Social Screen

	Annualized Return	Annualized Standard Deviation	Beta	Alpha	Sharpe Ratio	R-Square	# Observ
MSCI KLD 400 Social	10.92	14.51	0.98	0.02	0.73	98.46	120.00
S&P 500 - Total Return	10.86	14.68	1.00	0.00	0.72	100.00	120.00

Source: LPL Research, FactSet 08/31/18

Data are as of 8/31/18.

CONCLUSION

LPL Research believes analyzing a company's ESG factors as an integral part of traditional financial analysis can add value to investors' portfolios. As more information and products become available, we anticipate that these ideas may become even more widely accepted, perhaps to the point where they are standard considerations for most investment managers, making it much easier for investors to implement a portfolio that reflects their values. ■

IMPORTANT DISCLOSURES

The opinions voiced in this material are for general information only and are not intended to provide specific advice or recommendations for any individual. To determine which investment(s) may be appropriate for you, consult your financial advisor prior to investing.

All performance referenced is historical and is no guarantee of future results. Indexes are unmanaged and cannot be invested into directly. Unmanaged index returns do not reflect fees, expenses, or sales charges. Index performance is not indicative of the performance of any investment.

Any economic forecasts set forth in the presentation may not develop as predicted and there can be no guarantee that strategies promoted will be successful.

Investing involves risks including possible loss of principal. No investment strategy or risk management technique can guarantee return or eliminate risk in all market environments. There can be no assurance that any stated investment objectives will be achieved.

SRI and ESG investing are subject to numerous risks; chief amongst these is that returns may be lower than when decisions are based solely on investment considerations.

INDEX DESCRIPTIONS

The S&P 500 Index is a capitalization-weighted index of 500 stocks designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries.

MSCI KLD 400 Social Index is a capitalization weighted index of 400 U.S. securities that provides exposure to companies with outstanding environmental, social, and governance (ESG) ratings and excludes companies whose products have negative social or environmental impacts. The parent index is MSCI USA IMI, an equity index of large, mid and small cap companies. The Index is designed for investors seeking a diversified benchmark composed of companies with strong sustainability profiles while avoiding companies incompatible with values screens.

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