



Sustainable Investing Growth – We’ve Made It!....or Have We? (Part 2 of 2)

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INTRODUCTION

We recently published the first of two papers, titled “Sustainable Investing Growth – We’ve Made It!....or Have We?”. In this first paper, we examined the growth trends in the \$1.6 trillion of U.S. mutual funds and exchange-traded funds (ETFs) sourced to sustainable investing, as of the end of 2019. This \$1.6 trillion investment block consists of 977 funds with 3,460 share classes, all of which identify themselves as sustainable in their prospectus language¹. Since that time, sustainable fund assets, even in light of one of the most volatile months in stock market history, continued to climb ending the first quarter of 2020 at \$2.1 trillion in assets.

This recent surge seems to reflect a significant inflection point, in a growing trend that acknowledges the financial implications of sustainability risks in portfolios yet also recognizes an increasing interest on the part of stakeholders in promoting and achieving socially beneficial goals generally and environmental outcomes more specifically. Regardless of the motivation, this new era of rapid growth has surfaced a number of challenges and concerns regarding sustainable investing terminology, lack product clarity and variation in disclosure practices. While there may be alternative pathways to address these challenges, we propose three key standard setting recommendations for consideration and debate. These include the adoption of standardized sustainable investing definitions, creation of a generally accepted product classification framework and stepped up fund disclosures. We believe these steps will foster the continued growth and development of sustainable investing and allow this sector to reach its growth potential.

We are not alone in advocating for the adoption of standards in this area. The European Commission recently released the EU Taxonomy, as a classification tool to help investors and

¹ While definitions continue to evolve, sustainable funds pursue one or more of the following investing approaches or strategies: values-based investing, negative screening (exclusions), thematic and impact investing, ESG integration and shareholder/bondholder engagement and proxy voting. These are not mutually exclusive.

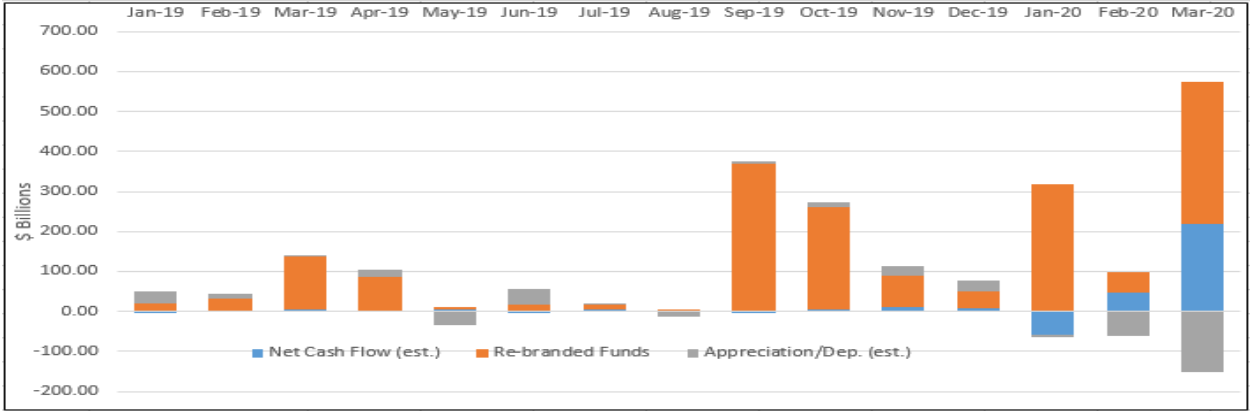
companies analyze the sustainability of potential investments. The federation of the Belgian financial sector, Febelfin, has created stringent guidelines around sustainable investment products. In the United States, the SEC has started a regulatory process with enormous potential consequences for the field.

During 2019, the total assets of mutual funds and ETFs associated with sustainable investing approaches expanded from \$0.4 trillion to \$1.6 trillion. The gain of \$1.2 trillion, or three hundred thirteen percent (313%), represents the largest ever calendar year increase for sustainable investment funds and it may arguably represent an inflection point for the segment as well as the broader funds industry. The gain of \$522.6 billion, in the first quarter of 2020, or a thirty-two percent (32%) increase in just three short months, reinforces this observation.

The data that we analyzed shows that three factors contributed to the \$1.2 trillion growth in assets. These include fund re-brandings, market appreciation and net cash flows. Based on our analysis, fund re-brandings represent the most significant contributing factor to the 2019 growth in sustainable investment fund assets in the United States, adding \$1.05 trillion or 86% to this total (reference Chart 1). In the first quarter of 2020, fund re-brandings contributed even more significantly to the growth in sustainable assets under management.

In this paper, we define the term “fund re-branding” and examine the reasons for the recent exponential increase in the number of fund re-brandings in the United States. We then discuss how fund re-brandings pose challenges and opportunities for professional advisors and investors who build sustainable investment portfolios.

Chart 1: Growth Components of U.S. Mutual Funds and ETFs: 1/2019 – 3/2020



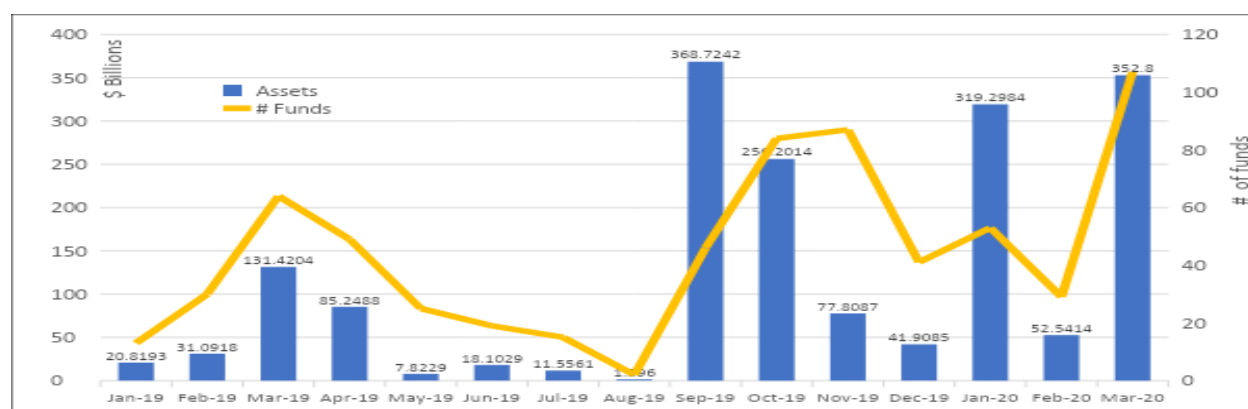
Notes of Explanation: Total net assets data sources: STEELE Mutual Fund Expert, Morningstar data. Estimates of growth attributable to market movement and net cash flows based on an analysis conducted by Sustainable Research and Analysis LLC. Estimated cash flows include flows into/out of sustainable money market mutual funds.

RE-BRANDING BACKGROUND

Re-branding is defined by the Cambridge dictionary as the act of changing the way that an organization, company, or product is seen by the public.² This definition describes the formal adoption of a sustainable investing strategy that has occurred, by an existing mutual fund or ETF, in the form of an amendment to its fund offering document or prospectus.

While the phenomenon of re-branding was already apparent in 2018 when some 90 funds and \$155.9 billion in assets were repositioned, fund re-brandings took off in 2019 when 47 separate fund groups formally shifted to sustainable investing strategies a staggering total of 460 funds (reference Chart 2). In the first quarter of 2020, fund re-brandings added 189 funds and \$724.6 billion in assets. This increase represents the largest number of fund re-brandings to-date and the second highest in terms of incremental asset gains.

Chart 2: Re-branded U.S. Mutual Funds and ETFs by Assets and Number: 1/2019 – 3/2020



Notes of Explanation: Total net assets data sources: STEELE Mutual Fund Expert, Morningstar data. Mutual fund and ETF re-brandings based on research, analysis and prospectus validation conducted by Sustainable Research and Analysis LLC.

RE-BRANDING DRIVERS

We identified several reasons for the increased pace of fund re-brandings attributable either to demand by investors or supply of fund companies for sustainable investment products. The increase in investor awareness and product demand appears to have gained momentum with the adoption of the Principles for Responsible Investment (PRI) and took another important leap forward, following the adoption of the Paris Climate Agreement at the end of 2015, as well as the enactment of the United Nations Sustainable Development Goals (UN SDGs) in that same year. It is important to note that to-date more than 2,900 PRI signatories, consisting of asset owners and asset managers worldwide, have agreed to incorporate ESG issues into their investment

² Cambridge University Press 2020

analysis and decision-making processes.³ The investment industry is implementing this commitment, in part, by offering a wide array of sustainable investment vehicles that includes the re-branding of existing products.

Some of the reasons why fund companies are re-branding their existing mutual funds and ETFs are:

- **THOUGHT LEADERSHIP:** to accelerate and showcase their transition and commitment to sustainable investing.
- **TIME TO MARKET ACCELERATION:** to avoid the time and expense linked to new product launches by immediately obtaining a critical 3-year performance track record (necessary for institutional investment consultants and fund rating companies).
- **TAX AVOIDANCE:** to sidestep the issue of “forced capital gains taxes” which occurs when an investor liquidates the shares in one fund to purchase a new fund with a sustainable investing option (particularly important for retail investors).
- **ACTIVE MANAGEMENT:** to create a potential opportunity for active management to deliver improved risk adjusted performance results through an ESG integration investment approach.

This expansion in the number and types of sustainable investment active and passively managed mutual funds and ETFs by leading conventional investment management firms has, unintentionally, added to the level of challenges and concerns in the sustainable investing marketplace.

CHALLENGES AND CONCERNS

As the number of sustainable mutual funds and ETFs has proliferated, reaching, as we noted earlier, some 977 funds with 3,460 share classes at year end 2019, several challenges and concerns have arisen. In this paper, we focus on the following three:

- **DEFINITIONAL CONFUSION:** there is increasing confusion on the part of investors, regulators, managers and others regarding the meaning of sustainable investing, and related to this, the financial and non-financial expectations or outcomes associated with these funds. In the process, concerns have surfaced regarding the possible compromise of an advisor’s fiduciary duties and responsibilities for acting in the best interests of their clients.

³ UN PRI website, Introduction to responsible investment, what are the principles for responsible investment, Principle 1

- **INVESTMENT PRODUCT CLARITY:** with the explosion of new mutual fund and ETF product offerings, it's becoming increasingly difficult to differentiate between various funds and their sustainable strategies and outcomes. In turn, this makes it more challenging for financial intermediaries and investors to align these funds with their investor's goals, objectives and values. As sustainable products continue to expand in number, assets and investors, there is a growing risk that fund strategies might diverge from expectations ("greenwashing") or may not align with investor beliefs or values and lead to disappointments or worse in the form of redemptions and possibly litigation.
- **DISCLOSURE GAP:** a widening disclosure gap is becoming evident, one that limits the ability on the part of investors to establish a link between the adoption of sustainable strategies, how such strategies may be impacting investment decisions as well as financial and, as relevant and appropriate, non-financial outcomes. At the present time, disclosure and transparency practices vary considerably.

Reflecting some of these concerns, the current Commissioner for the Securities and Exchange Commission (SEC), Hester Peirce, has criticized the ESG label for having no enforceable or common meaning.⁴ Her concern is that investible ESG strategies are currently designed in ways that prioritize companies with higher ESG scores and rewarding them with new cash flows as these are incorporated into ESG securities market indices that, in turn, stimulates demand for their securities. To date, sustainable index funds that are sector neutral global benchmarks constructed using environmental, social and governance (ESG) factors have gained limited traction. The SEC has recently sent examination letters to fund companies that have products that broadly market themselves as addressing environmental, social or governance issues.

CALL TO ACTION

While there may be alternative pathways to address the aforementioned challenges and concerns, we propose the following three key recommendations for consideration and debate:

- **ADOPTION of STANDARDIZED DEFINITIONS:** The absence of generally accepted definitions and standards to cover the spectrum of sustainable investing approaches continues to create confusion in the U.S. investment industry. For example, a common misunderstanding continues to occur with the term ESG integration and its confusion with social/ethical investing practices. Setting aside for a moment that the elements of what constitute "E", "S" and "G" are still being debated, the definition of ESG integration remains unclear and the concept is subject to confusion even as it is the most rapidly gaining sustainable investing strategy. A frequently cited definition and one that has been adopted by the CFA Institute refers to ESG integration as an investment strategy that takes into consideration, in a systematic and consistent manner, any relevant and material environmental, social and governance risks or opportunities. The consideration of ESG issues in investment analysis is intended to compliment and not substitute for

⁴ Scarlet Letters: Remarks before the American Enterprise Institute, Commissioner Hester M. Peirce, Washington DC, June 18 2019

traditional fundamental analysis that might otherwise ignore, overlook or understate such risks or opportunities. On the other hand, ethical or social investing relies primarily on screening out or excluding companies from investment portfolios for a variety of reasons, including ethical, religious, social as well as other strongly held beliefs, such as environmental concerns or involvement on the part of companies in specific business activities. These may include companies involved in the production or manufacturing of tobacco, firearms, alcohol, or even fossil fuel companies, to mention a few. Recently, values-based investing and ESG integration have become conflated. What is required to address this issue is the adoption of consistent widely accepted standards and definitions to cover the various sustainable investing approaches. As industry organizations, like Principles for Responsible Investment (PRI) and Sustainability Accounting Standards Board (SASB), continue to wrestle with this issue, a starting point may be the definitional framework outlined in our first paper and outlined below in Chart 3.

Chart 3: Sustainable Investing Strategies/Approaches Defined

Strategy/Approach	Definition
Values-based Investing	A strategy based on the guiding principle of investments that are based on a set of beliefs that contain a view toward achieving a positive societal outcome . Typically, this approach is executed via negative screening, divestiture or divestment.
Exclusionary Investing[^]	The exclusions of companies or certain sectors from portfolios based on specific ethical, religious, social or environmental guidelines . Traditional examples of exclusionary strategies cover the avoidance of any investments in companies that are fully or partially engaged in gambling, sex related activities, the production of alcohol, tobacco, firearms, fossil fuels or even atomic energy. These exclusionary categories have been extended, in recent years, to incorporate serious labor-related actions or penalties, compulsory or child labor, human rights violations and genocide.
Impact Investing	A still relatively small but growing slice of the sustainable investing segment. Impact investments are investments directed to companies, organizations, and funds with the intention to achieve measurable social and environmental impacts alongside a financial return . The direct capital in this strategy addresses challenges in sectors such as sustainable agriculture, renewable energy, conservation, microfinance, affordable and accessible basic services, including housing, healthcare, and education.
Thematic Investing	An investment approach with a focus on a particular idea or unifying concept . Clean energy, clean tech and gender diversity are a few of the leading sustainable investing fund themes. Investing in green bonds or low carbon emitting stocks, bonds and funds also fall into the thematic investing category.

ESG Integration	The investment strategy by which environmental, social and governance factors and risks are systematically analyzed and, when deemed relevant and material to an entity's long-term performance , influence the buy, hold and sell decision of a security. For these reasons, ESG integration is referred to as a value-based investing approach.
Engagement/Proxy Voting	Leverages the power of shareholder ownership in publicly listed companies using action-oriented approaches that rely on influencing corporate behavior through direct corporate engagement, filing shareholder proposals and proxy voting.

^referenced as negative screening strategies in our first paper, "Sustainable Investing Growth – We've Made It!...or Have We?"

- CREATION of ACCEPTED PRODUCT CLASSIFICATIONS:** Due to the lack of product clarity through a generally accepted fund classification framework, asset owners and their professional advisors are unable to properly classify, track, evaluate and analyze like funds based on their sustainable investing approaches. Not unlike the establishment of investment objectives, investment categories or investment styles, a widely adopted supplemental classification framework superimposed on top of investment classifications is likely required for sustainable funds. In this way, for example, funds that seek to emphasize the achievement of social impacts or societal outcomes can be differentiated from funds that restrict their efforts to identifying and considering relevant and material environmental, social and governance risks and opportunities throughout the research process. The adoption of a standardized supplemental classification framework for sustainable mutual funds and ETFs would also help alleviate confusion, misunderstanding and future investor disappointments or worse. Further, this should facilitate for investors and advisors the process of comparing products and determine what constitutes a sustainable investment that aligns with their objectives and values. Importantly, standardization should diminish the risk of greenwashing, where funds might exaggerate their credentials or conversely, investors might misconstrue the nature of the product offering. It also means investors and their advisors must spend more time understanding the investment approach that each fund manager is taking and the outcome they should expect. Morningstar has made attempts at this product classification issue, but their investment categories tend to be broad and lack granularity. For a proposed classification framework, refer to Appendix I.
- CLOSURE of DISCLOSURE GAP:** Sustainable investors who seek portfolios that achieve positive societal outcomes with their investments should have a way to track, evaluate and compare the range of outcomes linked to their investments. If this cannot be achieved, it is not possible to assess the fund manager's performance, in regard to sustainability, and substantiate the strategy's alignment with investor expectations. In the event of unexpected outcomes, investors should understand the reasons for such results. Mutual funds, exchange-traded funds (ETFs) and other similar investment vehicles are already required to publish semi-annual reports that describe the fund's

holdings and financial results. What is missing, at this time, are explicit sustainable disclosure mandates on non-financial outcomes for all funds. That said, some fund firms, including Calvert Investment Management, Neuberger Berman and Schroders, to mention just three, have recently begun to publish fund specific impact reports that describe, using selected metrics, how portfolios are performing with regard to sustainability and ESG considerations. Their actions are very much in line with what investors should expect to receive from such funds along with expanded insights into the how sustainability considerations are integrated into the investment process. The challenge fund companies and investment advisors face is developing credible ways to isolate the effect of ESG on performance. The European Union is already requiring ESG integrated fund companies to provide such information. The type and level of disclosures is likely to vary by fund as these should be calibrated to align with the character of each fund's sustainable investing commitments. In addition to encouraging stepped up voluntary disclosures, the SEC might consider promulgating a requirement for a discussion in fund annual reports of sustainable investment practices and outcomes, similar to the current requirement for a management discussion of fund performance results in annual reports.

CONCLUSION

Based on our analysis of the mutual fund and ETF offerings in the United States, sustainable investing, evaluated through the lens of mutual funds and ETFs, has experienced significant growth, through year-end 2019. The assets of U.S. sustainable investment funds reached \$1.6 trillion, with the primary driver of this growth being fund re-branding in ESG integration strategies. This movement, combined with new active and passive fund formations, has led to the expansion in the number and types of sustainable investment products available to investors. Unintentionally, these developments have led to an increasing confusion regarding a clear meaning of sustainable investing, thus preventing the closure of the mutual fund/ETF product reporting and disclosure gaps that current exist.

Even with the recent coronavirus pandemic and the breakdown in financial markets, growth in the sustainable investment sector is expected to continue into the foreseeable future. To experience meaningful growth in this sector, the concerns and confusions highlighted in this paper will need to be addressed, either in the form of voluntary actions or through SEC rule making initiatives similar to the regulations promulgated in other parts of the world to define sustainable investing. One example of such rule making initiatives is the unified European Union classification system, established in May 2018 by the Belgian Financial Sector Federation (Febelfin). It appears that the SEC is already leaning in this direction with its March 5, 2020 request for public comment on the framework for addressing names of registered investment companies and business development companies that are likely to mislead investors about a fund's investments and risks pursuant to The Names Rule. The Names Rule generally requires

that if a fund's name suggests a particular type of investment (e.g. containing "ESG" as an investment strategy) it must invest at least 80% of its assets in that manner.

We will continue to beat the drum for the adoption of standardized sustainable investing definitions, the creation of product clarity through the adoption of a generally accepted fund classification and the stepped-up disclosure practices commensurate with the core sustainable investing strategy adopted by each fund.

OUR AUTHORS



Michael Cosack (cosackm@impactwise.us) is a principal at ImpactWise and brings more than twenty years of business leadership experience, including the qualitative and quantitative analytical skills needed to implement programs and people in a meaningful, measurable and impactful way. Michael has spent most of his professional career advising the trustees on the investment and fiduciary responsibilities regarding their institutional funds. As an entrepreneur, he has built several organizations, including one of the largest independent investment consulting firms in the Greater Philadelphia region. His role at ImpactWise is to help institutional money managers, consultants and trustees explore, create and implement innovative impact investment strategies and solutions.

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Henry Shilling (henryshilling@sustainableinvest.com), Director of Research, Sustainable Research and Analysis LLC, a NYC-based independent provider of research focused on sustainable investing for the benefit of institutional investors. In addition, the firm provides consulting, training and education services targeted to institutional investors as well as financial intermediaries. Previously with Moody's Investors, Henry in more recent years initiated and coordinated Moody's efforts to expand disclosure and add transparency in research, ratings and analysis to the reflection of environmental, social and governance (ESG) risks. He also led the firm's effort to launch and implement a methodology for assessing green bonds world-wide.

Henry is the author of *The International Guide to Securities Market Indices* which was published in 1996 by International Publishing Corp., Chicago, Illinois. He is a contributor to *Money Market Funds in the EU and the US*, published in 2014 by Oxford University Press. He earned a B.A. in economics from Lehman College, City University of New York.

APPENDIX I:

Core Sustainable Investing Strategies Product Classification Framework illustration

The five core sustainable investing strategies that we have suggested include Values-based Investing, Exclusionary Investing, Impact Investing, Thematic Investing and ESG Integration Investing. Investee engagement and proxy voting strategies are generally employed alongside one of the five core strategies rather than on a stand-alone basis.

Core strategies describe the fund's overarching strategy, for example investing in companies that seek to achieve positive societal impact outcomes (Impact Investing) or in companies within a particular sector such as natural resources or climate focused instruments (Thematic Investing) or U.S. growth equity securities that also integrate ESG (ESG Integration Investing). In each instance, the core strategy could include one or more these approaches as secondary sustainable strategies.

Since ESG Integration Investing is the most widely used investing strategy, it is important to note that it may have three distinct forms: 1) ESG Integration Investing may be factored into investment decisions, 2) ESG Integration Investing will be factored into investment decisions accompanied by investee engagement, and 3) ESG Integration Investing will be factored into investment decisions, and while this is still the overarching strategy, additional approaches may also be employed, such as Exclusionary Investing or Impact Investing, to mention just two.

Fund Name	Core Sustainable Investing Strategy	Prospectus Language
Timothy Plan International ETF ⁵	Values-based Investing	The fund promotes biblically responsible investing . Its foundational principle of investing is that God owns everything. This is why Timothy funds take a pro-life, profamily approach to investing —not only to benefit the investor but the broader culture. This organization is firmly committed to running a mutual fund company with the integrity, excellence, and wisdom that brings honor and glory to our Lord Jesus .
City National Rochdale US Core Equity Fund ⁶	Exclusionary Investing	The fund may not purchase the stock or bonds of companies identified by the tobacco service of MSCI ESG Research. This service identifies those companies engaged in growing, processing or otherwise handling tobacco.

⁵ New fund launch 12/2019

⁶ Fund re-branded 1/2020

RBC Impact Bond Fund ⁷	Impact Investing	The advisor will select investments that seek to generate returns while simultaneously achieving positive aggregate societal impact outcomes . The advisor uses its impact methodology to measure the fund's investments on the basis of qualities that promote affordable quality shelter, small business growth, health and well-being, environmental sustainability, quality education, community development, diversity, reduced inequalities, and neighborhood revitalization .
PIMCO Climate Bond Fund ⁸	Thematic Investing	The fund invests opportunistically in a broad spectrum of climate focused instruments and debt from issuers demonstrating leadership with respect to addressing climate related factors . Given the long-term nature of the risks and opportunities presented by climate change and resource depletion, PIMCO may emphasize investment strategies that are more strategic, or long-term in nature, with less emphasis on short-term, tactical trading strategies. Additionally, PIMCO may engage proactively with issuers to encourage them to improve their environmental practices or preparations for a low carbon economy .
Eaton Vance Dividend Builder Fund ⁹	ESG Integration - Consideration	As part of the research process, portfolio management may consider financially material environmental, social and governance ("ESG") factors . Such factors, alongside other relevant factors, may be taken into account in the fund's securities selection process.
Brown Advisory Equity Income Fund ¹⁰	ESG Integration [^]	The Adviser assesses a company's Environmental, Social and Governance ("ESG") profile through conducting ESG research and leveraging engagement when appropriate through dialogue with company management teams as part of its fundamental due diligence process . The Adviser views ESG characteristics as material to fundamentals and seeks to understand their impact on companies in which the Fund may invest .
Goldman Sachs International Equity ESG Fund ¹¹	ESG Integration- Mixed	The Fund's ESG criteria are generally designed to exclude companies that are involved in, and/or derive significant revenue from, certain industries or product lines, including: gambling, alcohol, tobacco, coal, and weapons . The investment adviser conducts a supplemental analysis of individual companies' corporate governance factors and a range of environmental and social factors that may vary by sector. The investment adviser engages in active dialogues with company management teams to further inform investment decision-making and to foster best corporate governance practices using its fundamental and ESG analysis .

[^] distinction between engagement when appropriate through dialogue with company management teams as part of an adviser's fundamental due diligence process and engagement as an active owner on environmental, social and governance issues. Same applies to proxy voting and filing or co-filing shareholder proposals.

⁷ New fund launch 12/2017

⁸ New fund launch 12/2019

⁹Fund re-branded 11/2019

¹⁰ Fund re-branded 10/2019

¹¹ Fund renamed and re-branded 2/2018