SPONSORED INDUSTRY INTEL

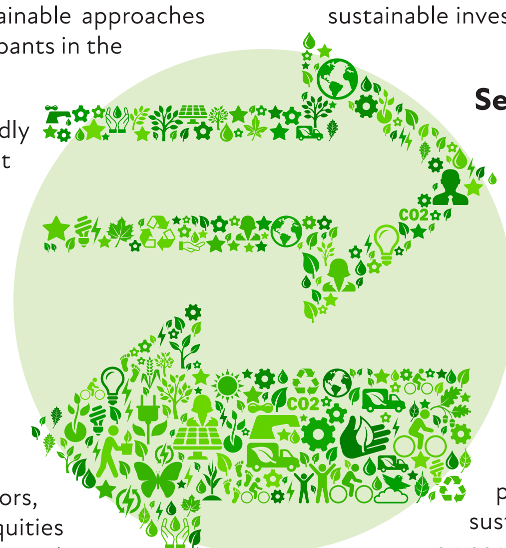
SUSTAINABLE INVESTING

A BIGGER UMBRELLA

There are multiple ways to define sustainable investing — and multiple motivations to pursue it.

"Sustainable investing" has entered the financial lexicon. More investors have adopted it as the preferred term to describe their approach to incorporating the material impacts of environmental, social and governance factors on their investments. But with the proliferation of diverse sustainable approaches available today, it can mean different things to different participants in the institutional investment world.

Thomas Kuh, head of ESG strategy at Morningstar Indexes, broadly defines sustainable investing "as an overarching category that includes climate, ESG and impact. Over the years, index and data coverage have gone from being on the country level to being global," he said. "It's also evolved through different phases from socially responsible investing, as it was initially called, to ESG. We're now at a point where the urgency of climate change, climate risk and climate transition has come to dominate investors' agendas."



Focus on development

Rob Harley, analyst and portfolio manager at Stewart Investors, offers a specific approach. The firm invests exclusively in the equities of high-quality companies that it believes are well positioned to contribute to — and benefit from — sustainable development. The latter refers to economic and human development that meet present and future needs without depleting the earth's environmental resources.

Stewart frames its approach in this way because "we've learned from history that as countries have grown richer, their populations have also become healthier, wealthier, better educated and, up to a point, happier. But these human development gains have come with growing wealth inequality and a huge environmental cost, as we're using up natural resources 70% faster than nature can regenerate them," Harley explained. "The world must find a different way of doing things, and we think sustainable investment can be part of that change."

Several objectives

Why do asset owners around the world pursue sustainable strategies?

The reasons range from the purposeful (to make the world a cleaner, better place) to avoiding risks, such as the negative impacts of environmental issues, to the purely financial (delivering alpha). And many institutional allocators today pursue both purpose and alpha, alongside a more granular understanding of how to approach and measure their sustainable investment portfolios.

Asset owners are expressing themselves very clearly on this point, said Hortense Bioy, Morningstar Sustainalytics' head of sustainable investing research. "We're hearing from some asset owners that the current state of climate investing isn't meeting their needs," she said. "Some have criticized benchmarks aligned with the Paris Agreement and certain climate transition metrics. Paris-aligned benchmarks are a regulator-driven initiative that aims to reduce carbon in portfolios, but they're quite constraining."

Asset owners have two primary goals, Bioy continued: To provide capital to companies that offer solutions to climate change and to encourage corporate decarbonization. They're more concerned about leveraging their position as large investors to foster real-world decarbonization than about their portfolios' carbon exposure.

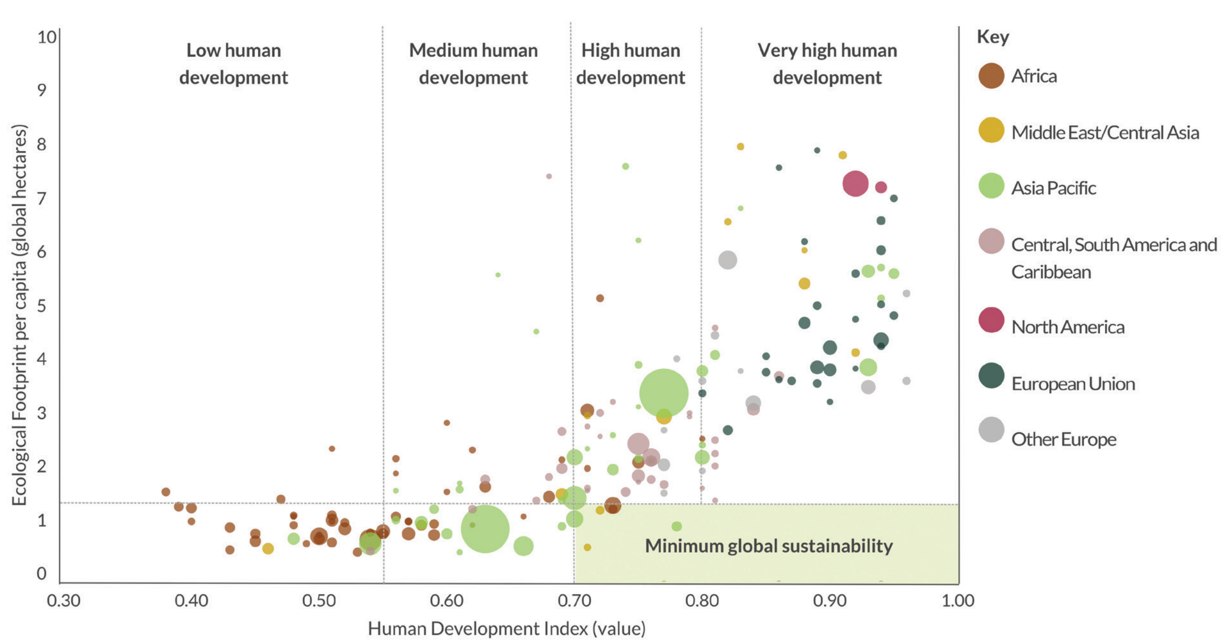
Pablo Berrutti, portfolio specialist at Stewart Investors, cites several objectives that sustainable investing seeks to achieve. The first is simply to generate good performance. "Some asset owners focus on ESG ratings and sustainability considerations," he said. "But ESG is usually just one of many criteria they use to make decisions. They want to know how we intend to generate attractive long-term returns and how our investment process connects with our investment philosophy to accomplish that."

Berrutti also cited government reporting requirements as a reason why asset owners pursue sustainable strategies. The U.K. and New Zealand, for example, have mandatory climate change disclosures. Asset owners in those jurisdictions need their investment managers to deliver disclosure-friendly information.

Ultimately, Berrutti said, "asset owners' motivation comes down to two things. One, How does the incorporation of sustainability enhance a manager's investment process? And two, How can shareholders use their influence as stewards to encourage companies to improve their sustainability efforts, reduce risk and capture opportunities?"

Resource Consumption Increases as Human Development Rises

Global Footprint Network — Human Development Index and Ecological Footprint of Countries



Source: Footprint Data Foundation, York University, Global Footprint Network, 2023 National Footprint and Biocapacity Accounts.
Note: last three years are estimates. Downloaded May 30, 2024, from https://data.footprintnetwork.org. Latest country data for the ecological footprint is 2021.
Graph scale is limited to 10 on the ecological footprint axis and excludes countries with either a footprint above 10 or where no data is available.

DATA AND BENCHMARKING ADVANCE

Developments in sustainability data and the resulting products are moving fast – and need constant vigilance.

The world of sustainable investing continuously evolves as technologies, data and marketplace factors advance at a dizzying pace. While institutional allocators continue to follow the traditional approach to benchmarking — comparing the performance of their portfolio to that of a broad representative index — new and specialized sustainable benchmarks have also gained many adherents. Either way, it requires regular monitoring of innovations across the space.

Bioy of Morningstar Sustainalytics said, "Sustainable strategies are typically benchmarked against a broad-market index. But new strategies call for new indexes, which explains the rise of sustainable indexes over the last 10 years." According to the Index Industry Association, there currently are more than 50,000 sustainable investment indexes.

"If you want to measure your sustainable strategy's risk, return, ESG quality, carbon profile, etc., you need to compare it not just against a sustainability benchmark, but also versus the broad market," Bioy said.

Institutions are asking sustainable index providers for more than benchmarks: They want data and insights that can enhance their analysis and decision-making.

Asset owners are focusing on how they should invest as the transition from fossil fuels to other energy sources unfolds, said Kuh of Morningstar Indexes. In the last year or so, the climate research team at Morningstar Sustainalytics has introduced its Low Carbon Transition Rating.

LCTR not only provides insights for investors on traditional metrics for carbon footprint, but also uses forward-looking data that examines companies' net-zero plans and the related capital expenditures they need to make. "This gives investors a clearer sense of whether companies are actually following through on their net-zero plans and moving on to pathways that, in the future, will meaningfully reduce their carbon footprint," Kuh said.

Not there yet

Asset owners and managers have long complained about the lack of standardization in the data, metrics and disclosure requirements used to evaluate sustainable investments. Some index providers believe that things are moving in the right direction, while acknowledging that true standardization will take years to happen.

"ESG is usually just one of many criteria that asset owners use to make decisions. They want to know how we intend to generate attractive long-term returns and how our investment process connects with our investment philosophy to accomplish that.

- Pablo Berrutti
Stewart Investors

"There's more and better quality ESG data now than five years ago, because investors have engaged with companies to request that information," said Bioy of Morningstar Sustainalytics. "But there is still no standardization because disclosure remains voluntary in most markets. This is changing, though. The European Commission has enacted its Corporate Sustainability Reporting Directive, for which the first reports will be published in 2025. The International Sustainability Standards Board has consolidated several standards into one that countries are starting to adopt as their mandatory framework."

Standardization remains uncertain in the U.S., Bioy added. The Securities and Exchange Commission adopted a climate disclosure rule in March 2024, only to pause it in the face of political opposition. A federal appeals court will hear arguments on the rule's legality.

Stewart's Berrutti shares similar concerns: "To the extent we look into ESG data providers' offerings and the substance of their data, we see a lot of variation and big discrepancies. Standardization seems a long way off."

"We're quite cautious, skeptical even, of ESG scores because measurement methodologies vary greatly among providers," Berrutti explained. "It can be difficult to know whether you're comparing apples to apples. Often the scores seem to be based on the previous year's data, and they get updated only annually. The data is also backward looking, which means it can't take into account a company's ambitions, future strategies, where it wants to go — which is the most important thing for us as investors."

"We can now collect and analyze information that wasn't even available before and do it much faster than ever. This capability will fundamentally transform how sustainable investment is practiced.

- Thomas Kuh
Morningstar Indexes

Focus on biodiversity

Index providers are actively creating new products that meet asset owners' needs.

Kuh referenced Morningstar Sustainalytics' Low Carbon Transition Rating as the basis of a new index. "We developed a benchmark to track carbon transition leaders that builds on the LCTR's management assessment. It reflects not only the historical trajectory of these companies' carbon profiles, but also where they're going," he said.

Institutions are expressing considerable interest in biodiversity, Kuh said, which is adjacent to, and intersects with, climate change — making it a greater priority for sustainability investors. "It's fair to say that we should expect biodiversity to become increasingly important to investors concerned about transitioning to a low-carbon economy," he said. "Climate change's impact on biodiversity, in terms of species loss and depletion, is profound and has long-term ramifications."

A BOTTOM-UP APPROACH

Sustainability must be integral to a company's business model.

Equities manager Stewart Investors was founded in 1988 on the core principle of "careful, considered and responsible management" of its clients' funds. Its commitment to sustainability in its bottom-up stock selection has been ironclad ever since.

Berrutti described the firm's investment philosophy: "Sustainable investing means finding high-quality companies that are contributing to, and benefiting from, sustainable development, which means operating within environmental limits while contributing to human development, including the attainment of higher incomes, living standards, education and access to healthcare and technology," he said. "Contributing to and benefiting from sustainable and human development must be core to the company's business model because that is what will drive long-term value."

Stewart's investment approach is bottom-up and not driven by themes or macro factors. Harley said that company quality must go hand-in-hand with sustainability. "We consider whether every company has a management team that acts with integrity and takes a long-term view, a competitive and resilient franchise, and conservative financials," he said.

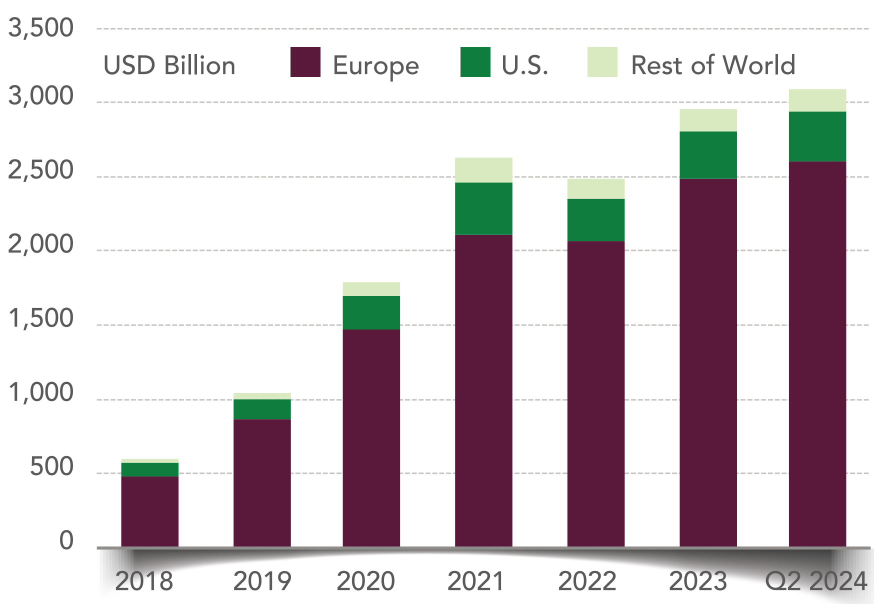
Harley shared four key sustainability considerations used in stock selection. They include a company's commercial proposition to offer products and services that solve difficult problems, meet important needs and help people do more with less; a low operational impact along its value chain; a committed sustainability ethos; and a context that's positioned to benefit from evolving regulations and consumer preferences.

Attractive opportunities

Although Stewart is a bottom-up investor, there are certain sectors in which it tends to find appealing opportunities, including healthcare, information technology, software and digitalization, Harley said. The intersection of industry and technology is particularly interesting as well, he noted. Companies that formerly were straightforward industrial producers now use different business models. They're seizing opportunities that arise because of digital connectivity, processing efficiency and automation.

Sustainable Funds AUM Has Quintupled Since 2018

Global Assets in Sustainable Mutual Funds



Source: Morningstar Direct. Data as of June 2024, excluding money market funds, funds of funds, and feeder funds. For Canada and the U.S., the number of funds includes funds of funds and feeder funds (these are, however, excluded from flow and asset calculations). For Japan and South Korea, the number of funds, flows, and assets includes funds of funds and feeder funds.

Berrutti cites a couple of Stewart's current holdings as examples of what it seeks in companies. "DiaSorin, an Italian diagnostics company, is using artificial intelligence to help develop its next generation of diagnostic tests," he said. "One of these tests helps to separate bacterial infections from viral infections, which hadn't been possible. If the test comes to market, it could reduce the overuse of prescription antibiotics, which reduces human resilience to diseases due to antimicrobial resistance."

Another promising holding is an Indian company, Marico. "Marico makes healthy coconut-based products for skincare, shampoo and food," Berrutti said. "It has a very tight and sustainable supply chain focused on those coconut products, engaging directly with farmers as it buys one in 10 coconuts across the Indian subcontinent. As Indian consumer standards of living increase and widen access to hygienic shampoos, soaps and the like, Marico should prosper."

THE VIEW AHEAD

Sustainable investing is a hotbed of innovation across asset classes, though its shift into the mainstream may come in fits and starts.

Asset owners currently favor equities for their sustainable portfolios — but fixed income is gaining traction and appears headed for larger allocations.

Within sustainable fixed income, investors are most enthusiastic about green bonds, according to Bioy of Morningstar Sustainalytics. "Green bonds are at the intersection of climate, finance and impact," she said. "Investors like them because they use quantitative metrics to measure how specific projects meet their environmental goals. Compared to public equities, they offer a better way to assess a sustainable investment's impact."

Private markets play a pivotal role in the climate transition, Kuh added. "They're where a lot of the new and emerging technologies are being incubated. At Morningstar, we have the benefit of access to private markets data through PitchBook. We'll be increasingly taking advantage of access to that information to help investors think about where the new technologies are coming from and how the transition will be financed," he said.

Innovative future

For Kuh of Morningstar Indexes, the big story is data as the foundation on which sustainable investing strategies are built. "We are in a world of big data, advanced computing capabilities and artificial intelligence. Our ability to gather and analyze new types of data is transforming business practices in many industries. We can now collect and analyze information that wasn't even available before and do it much faster than ever — for example, geospatial data on biodiversity-sensitive areas. This capability will fundamentally transform how sustainable investment is practiced," he said.

"We consider whether every company has a management team that acts with integrity and takes a long-term view, a competitive and resilient franchise, and conservative financials.

- Rob Harley

Stewart Investors

What does sustainable investing look like in the longer term? Stewart's Harley expects to see a gradual shift in the sense that ultimately, sustainability should be absorbed into the investment mainstream. "I think the importance and idea of sustainable investing will gradually take hold, but the process won't be fast, uniform or neat. It'll likely be patchy and staccato. Parts of the industry will resist and move slowly," he said.

Eventually, Harley continued, "attention to things that once seemed unusual and far reaching will become commonplace and seen as normal. Sustainability will enter the mainstream, and when that happens, people will probably stop talking about it as something distinct. It'll become a bit like electricity a century ago or wireless connectivity this century — something that's just there that people take as a given."

Bioy of Morningstar Sustainalytics sees ongoing evolution. "ESG is moving from voluntary to regulated, and from proprietary to market-level standards. It's being shaped by disclosure regulation," she said.

"The climate transition and the opportunities stemming from it represent a fundamental economic transformation," Bioy added. "There is substantial opportunity, along with high uncertainty and risk. One way to reduce that uncertainty is to recognize that investors can't do it alone. We need effective public policy related to climate change. It's critical that asset owners make their voices heard in the policy arena. Getting policy in place across the key markets will make a huge difference as the climate transition evolves." ■

"ESG is moving from voluntary to regulated, and from proprietary to market-level standards. It's being shaped by disclosure regulation.

- Hortense Bioy

Morningstar Sustainalytics