ESG: The Intersection of Investing and Ideology

Profits with a Purpose

FOREWARD

Historically, investing and philanthropy have been distinctly different disciplines. The investor seeks a competitive return on capital while the philanthropist seeks the betterment of society without the expectation of profit. However, a significant trend has shown that the two aims are no longer mutually exclusive. In rapidly growing numbers, modern investors have made their newfound objective clear: they want their capital working not just for themselves, but also for others. The increasing size, scale, and scope of 'sustainable investing' has shown that this movement is here to stay, and its impact on investing as a whole has been indelible.

HISTORY

The origins of sustainable investing are many, yet almost all have their roots in the concept of conscious capital allocation in accordance with ideological objectives. That is to say, investing with individual values in mind.

One of the most prominent precursors to this modern notion was organized religion, whose precepts precluded certain financial practices. Notable examples include laws against usury (i.e.,

KEY TAKEAWAYS

The increasing size, scale, and scope of 'sustainable investing' has shown that this movement is here to stay, and its impact on investing as a whole has been indelible.

A broad consensus has emerged amongst academics and industry professionals: sustainable investing may not sacrifice performance.

Available data suggests that the most sustainably savvy firms have actually boosted their performance because of their focus on these factors, not in spite of it.

Sustainable investing now comprises a significant share of global assets.

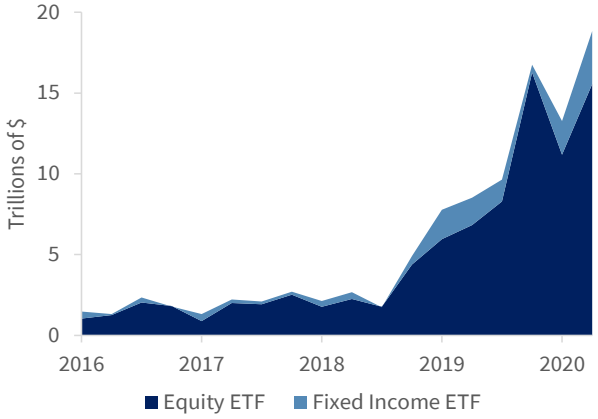
The trend in sustainable investing is neither transitory nor insignificant, as evidenced by the steadily increasing volume of sustainable products and the incorporation of ESG components into traditional financial research.

lending money at unreasonably high rates of interest) within both Christianity and Islam. Over time, different religious doctrines encouraged the faithful investor to divest of assets or businesses tied to 'sinful' activities (including the slave trade, weapons, alcohol, tobacco, and a variety of other industries).

By the 20th century, this approach had evolved to such an extent that it encompassed all activities deemed to be 'socially responsible investing' (SRI), including the consideration of environmental and governmental objectives. An emblematic example of the effective application of SRI was its prominent role in ending the apartheid regime in South Africa from the 1970s through the 1990s. A coordinated effort by international investors sought to divest assets tied to South Africa, exerting significant economic pressure upon the regime. The pressure ultimately became so great that South African business leaders banded together to call for an end to apartheid. In addition to international sanctions by the United Nations and other governments, this economic pressure from responsibly-minded investors has turned out to be a crucial component in effecting significant social and governmental change.

Fast forward to 2020— though the 'E' for Environment and the 'G' for Governance have typically been the more important aspects of ESG and more readily measured, the COVID-19 pandemic and social unrest across the country have turned the spotlight on the 'S' for Social. Increased focus is being placed on how companies prioritize work place safety for their employees, safety for their customers, and work hours and flexibility for employees to work from home if possible. Investors are also looking to see whether companies have diversity and anti-bias policies in place and if they are actually backing those policies and giving back to their communities. All of this awareness has influenced a record amount of investment in sustainable funds in the United States. In fact, in the third quarter of 2020, the value of assets invested in exchange-traded sustainable funds in the US reached a record $18.84 trillion, almost doubling from the beginning of the year.

Value of Assets Invested In Sustainable ETFs



Source: Bloomberg, as of 9/30/2020

DEFINITIONAL DISCREPANCIES

Sustainable investing can be generally defined as conscious capital allocation in accordance with ideological objectives. That is, investing with individual values in mind. Admittedly, this is an extraordinarily broad framework. However, it is fitting given that the scope of sustainable investing is itself similarly broad, mirroring the varied spectrum of human virtues and values. Furthermore, a broad framework has been utilized in sustainability analysis because a specific standard that has been universally adopted does not yet exist. A discrete definition of 'sustainable investing' that is both widely embraced and encompasses all aspects of the practice has yet to be penned.

In fact, even amongst the leaders in the field, wide discrepancies exist in sustainability ratings. Most of these discrepancies can be attributed to variability in reporting standards and availability of data. Specifically, large-capitalization companies generally enjoy greater coverage and higher ratings than their mid- or small-capitalization peers, while companies domiciled in jurisdictions with higher sustainability reporting standards, such as Europe, also enjoy greater coverage and higher ratings than companies domiciled in jurisdictions with relatively lower sustainability standards (e.g., the United States).

SUSTAINABILITY RATINGS

A notable anecdotal example of sustainability rating disparity can be found in the comparison of Tesla, an electric car manufacturer, and General Motors (GM), which primarily manufactures traditional combustion engine vehicles. The Sustainalytics scores of each company can be found below.* Tesla is often regarded as a quintessential sustainable company, given that its overarching business model focuses on the aggressive reduction of carbon emissions through the production of electric vehicles. Yet, it still scores lower on its total ESG score than GM. More ironic still, both score lower than Exxon Mobil, one of the biggest producers of fossil fuels in the world. While Tesla logically holds the highest environmental score, the weighting of each of the governance and social scores results in Tesla holding the the lowest total score amongst all three companies.

	TESLA	GM	EXXON
E	**78.4**	9.5	55.6
S	2.7	73	**76.2**
G	8.1	**93.2**	41.1
TOTAL	24.3	60.8	**68.2**

Source: Bloomberg, as of 10/21/2020

* Sustainalytics is a leader in the field of scoring companies on sustainability criteria

SHIFTING THE PERFORMANCE PARADIGM

While definitional discrepancies between ratings agencies abound and ESG ratings contribute only a piece of the performance puzzle, a broad consensus has emerged amongst academics and industry professionals: sustainable investing may not sacrifice performance. On the contrary, preliminary evidence indicates that sustainable investing actually contributes to outperformance in respect to both alpha and beta (i.e., return and volatility). Given that sustainable investing focuses on non-monetary elements, these findings would appear to be paradoxical. How could firms focusing on factors beyond profitability outperform their peers that have no such constraints? This is made all the more curious when one considers that most sustainably-minded investors are generally willing to accept marginally lower returns in exchange for the intangible benefits that a sustainable firm renders to society at large. Yet, over the long term, available data suggests that the most sustainably savvy firms have actually boosted their performance because of their focus on these factors, not in spite of it. Turning from stock to bond performance, data suggests that a focus on sustainability does not necessarily contribute to either alpha or beta. However, as with stocks, sustainable bonds may not sacrifice performance in any significant fashion. As measured by the Bloomberg Barclays MSCI Corporate Investment Grade indices, the SRI index tracked its non-SRI index almost identically.

SRI vs Non-SRI Index: No Meaningful Difference

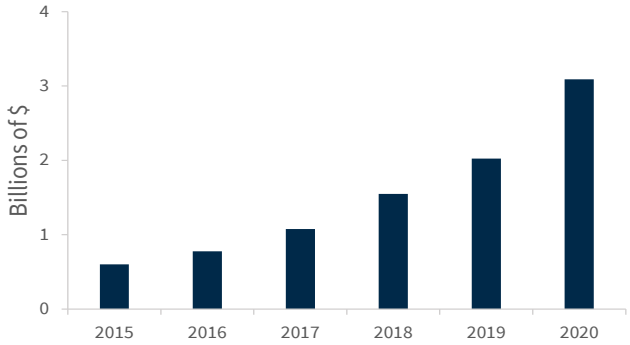
Source: FactSet, as of 10/21/2020

Separately, the highest scoring sustainability companies around the world enjoy a significantly lower average cost of capital relative to their lowest scoring peers, a finding that is consistent across sectors.

FOLLOW THE FUND FLOWS

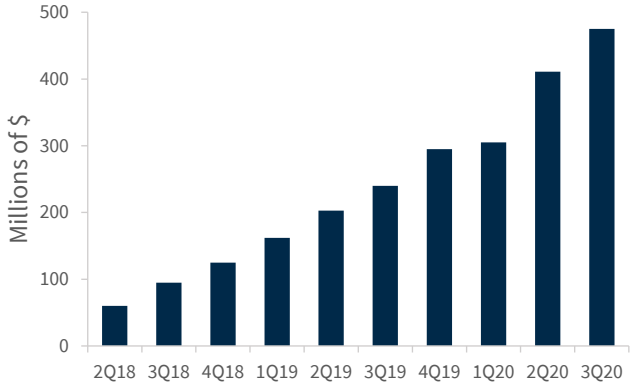
Aside from performance metrics, the other most significant trend in sustainable investing has been its rapid and prolific growth over the past two decades. Broadly defined, sustainable investing now comprises a significant share of global assets as net fund flows to ESG mutual fund strategies have accelerated at a rapid pace. At Raymond James, there has been a similar trend in the growth of asset flows to ESG focused strategies, which have more than tripled in less than two years. This trend has held for individual products (mutual funds and ETFs) as well as for the Freedom ESG portfolios. It is readily evident that the movement towards sustainable investing is broad in both scale and scope, and is not limited to any particular investor classification.

Raymond James Mutual Funds & ETFs



Source: Raymond James Mutual Funds Research, as of 10/21/2020

Raymond James Freedom ESG Portfolios



Source: Raymond James Asset Management Services, as of 10/26/2020

INDELIBLE IMPACT

In short, the trend in sustainable investing is neither transitory nor insignificant, as evidenced by the steadily increasing volume of sustainable products and the incorporation of ESG components into traditional financial research. At the intersection of investing and ideology, this approach is a force to be reckoned with, and its sheer size, scale, and scope warrants attention.

All content written and assembled by the Investment Strategy Group.

ADDITIONAL DISCLOSURES

Views expressed in this newsletter are the current opinion of the authors, but not necessarily those of Raymond James & Associates or your financial advisor. The authors' opinions are subject to change without notice. Information contained in this report was received from sources believed to be reliable, but accuracy is not guaranteed. Past performance is not indicative of future results. Investing always involves risk and you may incur a profit or loss. No investment strategy can guarantee success. Cover Image source: Getty Images.

This is not a recommendation to purchase or sell the stocks of the companies pictured/mentioned. Be sure to contact a qualified professional regarding your particular situation before making any investment.

Inclusion of indexes are for illustrative purposes only. Indices are not available for direct investment.

Exchange-traded funds are designed to provide investment results that generally correspond to the price and yield performance of their respective underlying indexes, the funds may not be able to exactly replicate the performance of the indexes because of fund expenses and other factors.

Every type of investment, including mutual funds, involves risk. Risk refers to the possibility that you will lose money (both principal and any earnings) or fail to make money on an investment. Changing market conditions can create fluctuations in the value of a mutual fund investment. In addition, there are fees and expenses associated with investing in mutual funds that do not usually occur when purchasing individual securities directly. Investors should consider the investment objectives, risks, charges and expenses of an exchange traded products and mutual funds carefully before investing.

Bond prices and yields are subject to change based upon market conditions and availability. There is an inverse relationship between interest rate movements and bond prices. Generally, when interest rates rise, bond prices fall and when interest rates fall, bond prices generally rise.

ESG investment refers to the composition of portfolios by the active selection of only those companies that meet a defined ranking hurdle established by environmental, social and governance criteria. This investment strategy may result in investment returns that may be lower or higher than if decisions were based solely on investment considerations. Graphs included are for illustrative purposes only and are not intended to reflect the actual performance of any security. The figures include the Freedom balanced ESG, balanced with growth ESG and growth equity ESG portfolios.

Additional considerations should be taken into account when considering a fee-based account as an alternative to paying commissions, including the anticipated level of trading activity and use of the products and services available in the account. You should understand that the annual advisory fee charged in the Freedom Account program is in addition to the management fees and operating expenses charged by mutual funds. These additional considerations, as well as the Freedom fee schedule, are listed more fully in the Client Agreement and the Raymond James & Associates Wrap Fee Program Brochure.

Bloomberg Barclays MSCI Sustainability Index: The index is designed to positively screen issuers from existing Bloomberg Barclays fixed income indexes based on MSCI ESG Ratings, which are an assessment of how well an issuer manages ESG risks relative to its industry peer group. ESG Ratings are available for corporate, sovereign, and government-related issuers. The minimum threshold applied to Bloomberg Barclays fixed income indexes is an ESG rating of BBB or better.

Bloomberg Barclays MSCI Socially Responsible (SRI) Index: The index is designed to negatively screen out issuers from existing Bloomberg Barclays fixed income indexes that may be involved in business lines or activities that are in conflict with investment policies, values or social norms. These indexes use MSCI Business Involvement Screening Research (BISR) and MSCI ESG Controversies to identify exposure to screened issues.

RAYMOND JAMES®

INTERNATIONAL HEADQUARTERS: THE RAYMOND JAMES FINANCIAL CENTER
880 CARILLON PARKWAY, ST. PETERSBURG, FL 33716