BETTER MARKETS

ESG

FACT SHEET

ESG Investing is Here to Stay

The expression that people "vote with their feet" has never been more true than in the case of investing with regard to environmental, social, and governance (ESG) factors. Although in the case of ESG investing, perhaps the expression should be that people vote with their money. By year-end 2022, investor assets in sustainable investments amounted to $8.4 trillion, or about 12.6% of all U.S. assets under management.[1] And between 2019 and 2022, the share of index funds with an ESG mandate nearly doubled, from 3% to 5%.[2] These statistics demonstrate that investor demand for ESG funds means ESG investing is here to stay.

What is ESG?

ESG investing is a form of sustainable investing that considers environmental, social, and governance factors to judge an investment's financial returns and its overall impact.[3] Each of the three terms in "ESG" encompasses a variety of important aspects of corporate planning and operations that investors want to know about before deciding whether to invest in a company.

Environmental criteria reflect how a company contributes to, or mitigates, degradation of the environment. The most prominent example is a company's approach to climate change caused by greenhouse gas emissions: How does a company contribute to climate change, and how is the company addressing those risks and the climate change problem more generally? Environmental criteria may also reflect a company's energy use, its handling of waste and other pollutants, and its position on deforestation and other issues of natural resource conservation.

Social criteria examine a wide range of issues about social relations. A significant aspect is how the company treats its employees and whether it provides them with fair compensation and benefits. These factors also reflect the composition of a company's workforce: Does it reflect racial and gender diversity, and, importantly, is that diversity reflected up and down the corporate ladder? The "social" aspect of ESG also concerns whether the company's vendors reflect its own stated values and where the company stands on human rights issues.

Governance criteria deal with how well a company is managed by its leadership and whether the company has sufficient controls in place to ensure management serves the interests of, and is accountable to, various company stakeholders. Important components include executive

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1 Ryan Ermey, *What is ESG Investing: A beginner's guide to choosing a sustainable fund*, CNBC (May 1, 2023), https://www.cnbc.com/2023/05/01/beginners-guide-to-esg-investing.html.

2 National Bureau of Economic Research, *Investors' Willingness to Pay for ESF Funds*, https://www.nber.org/digest/20231/investors-willingness-pay-esg-funds.

3 Alana Benson, *ESG for Beginners: Environmental, Social, and Governance Investing*, Nerdwallet (Feb. 21, 2023), https://www.nerdwallet.com/article/investing/esg-investing.

compensation that produces the right incentives for management, adequate board oversight, and robust auditing and other controls. Governance criteria also evaluate how the company treats shareholders and whether it provides them with the full and fair right to participate in corporate governance by voting through the proxy process.

Because investors are increasingly using the ESG criteria to make investment decisions that align with their core values, they need access to information about the degree to which companies have incorporated the ESG considerations into their structures and operations. This information enables investors to tailor their investment decisions and allocate their capital in ways they think are most effective in advancing their personal values. More disclosure about how companies are actually incorporating the ESG factors into their businesses will also help make those factors a reality. That, in turn, means progress toward increasing the sustainability, fairness, and quality of life our society can maintain. In short, to the extent profit-seeking companies see value in taking steps to prevent the ongoing degradation of the environment, address racism and sexism, reduce income inequality, and prevent fraud and other corporate malfeasance, all at the insistence of profit-seeking investors, the results will be market-based solutions, or at least mitigants, of some of our societies' most vexing problems.

Since roughly 2006, when the acronym "ESG" was first coined, more and more investors have been basing their investment decisions at least in part according to the way that companies incorporate the ESG factors into their operations, risk assessments, and planning processes. Indeed, investor demand has driven the growth of ESG investing.

Investors Continue to Demand ESG Investments

As discussed above, sustainable investments amounted to $8.4 trillion, or about 12.6% of all U.S. assets under management, by the end of 2022. In other words, 1 in every 8 U.S. investor dollar is in a sustainable fund.[4] And investors are increasingly choosing ESG criteria. According to a study of more than 1,000 global investors, 89% had adopted ESG in 2022, up from 84% in 2021.[5] Deutsch Bank found that more than half of investors (53%) regarded climate change as the most important factor affecting their investment decisions in 2022, up from 47% in 2021. A PwC survey in 2022 found that ESG issues are now among investors' top five concerns.[6] And PwC also estimated that ESG-focused institutional investment will rise 84% to $33.9 trillion in 2026, making up 21.6% of assets under management.[7] Bloomberg has gone even further, estimating that overall ESG assets

4 Ermey, supra note 1.

5 Coryanne Hicks, *ESG Investing Trends for 2023*, U.S News & World Reports (Jan. 10, 2023), https://money.usnews.com/investing/investing-101/articles/esg-investing-trends.

6 Katie Mehnert and Hillary Homes, *What Investors Should Expect for ESG in 2023*, Nasdaq (Dec. 8, 2022), https://www.nasdaq.com/articles/what-investors-should-expect-for-esg-in-2023.

7 Leah Malone and Emily B. Holland, *ESG: Trends to Watch in 2023*, Harvard Law School Forum on Corporate Governance (Mar. 4, 2023), https://corpgov.law.harvard.edu/2023/03/04/esg-trends-to-watch-in-2023/.

may reach $53 trillion by 2025, representing more than a third of the $140.5 trillion in projected total AUM.[8]

The flow of money into sustainable funds buttresses these estimates. Inflows into ESG funds remained positive in 2022 despite market turmoil, with net inflows for U.S. ESG funds at $3 billion.[9] And ESG funds accounted for 65% of all inflows into European ETFs in 2022, up from 51% in 2021.[10] Non-ESG funds, by contrast, suffered outflows throughout 2022.[11] Similarly, in the first quarter of 2023, ESG funds enjoyed a quarter of net inflows, beating non-ESG funds, which lost money. Net inflows hit $25.5 billion across ESG debt, equity, and multi-asset funds, the best quarter since early 2022.[12] Investors are also willing to pay a premium for ESG index funds. Fund investors were willing to pay up to 28 basis points, or 0.28 percent annually, more for ESG funds. This is triple the 9-basis point premium they paid in 2019.[13]

Issuers have responded to investor demand with a multitude of ESG investing options. The U.S. Sustainable Investment Forum identified 645 registered investment companies with $1.2 trillion sustainable investment assets under management in 2022, including 444 mutual funds and 177 ETFs. The U.S. SIF also identified 383 alternative investment vehicles in 2022, including private equity and venture capital funds, hedge funds, and real estate investment trusts or other property funds, managing $762 billion in assets under management that considered ESG criteria.[14] Finally, the roughly 4,000 signatories to the Principles for Responsible Investment (PRI), a financial industry initiative that helps firms integrate environmental, social, and governance criteria into their investment and ownership decisions, represented more than $120 trillion of assets at the end of 2021, up from just $10 trillion in 2007.[15]

Investors Are Not Demanding Investments with an Anti-ESG Focus

Investor demand for ESG investments stands in sharp contrast to the lack of demand for investments with an anti-ESG focus. Anti-ESG investments arose in response to criticism of sustainable investing. However, these funds do not appear to be catching on with investors.

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8 *ESG assets may hit $53 trillion by 20925, a third of global AUM*, Bloomberg (Feb. 23, 2021), https://www.bloomberg.com/professional/blog/esg-assets-may-hit-53-trillion-by-2025-a-third-of-global-aum/.

9 Ted Godbout, *Skepticism Aside, Asset Managers Push Forward with ESG Development*, National Association of Plan Advisers (May 19, 2023), https://www.napa-net.org/news-info/daily-news/skepticism-aside-asset-managers-push-forward-esg-development.

10 Emma Boyde, *ESG accounts for 65% of all flows into European ETFs in 2022*, Financial Times (Jan. 13, 2023), https://www.ft.com/content/a3e9d87f-fa6f-4e5e-be6e-e95b42af2fec.

11 Valentijn van Nieuwenhuijzen, *How Sustainability is Transforming the Economy and Creating Opportunities for Investors*, Goldman Sachs (Apr. 20, 2023), https://www.gsam.com/content/gsam/us/en/institutions/market-insights/gsam-insights/perspectives/2023/how-sustainability-is-transforming-the-economy.html.

12 Tommy Wilkes and Patturaja Murugaboopathy, *Banking turmoil dampens shine of ESG funds at end of strong Q1*, Reuters (Apr. 6, 2023), https://www.reuters.com/business/sustainable-business/banking-turmoil-dampens-shine-esg-funds-end-strong-q1-2023-04-06/.

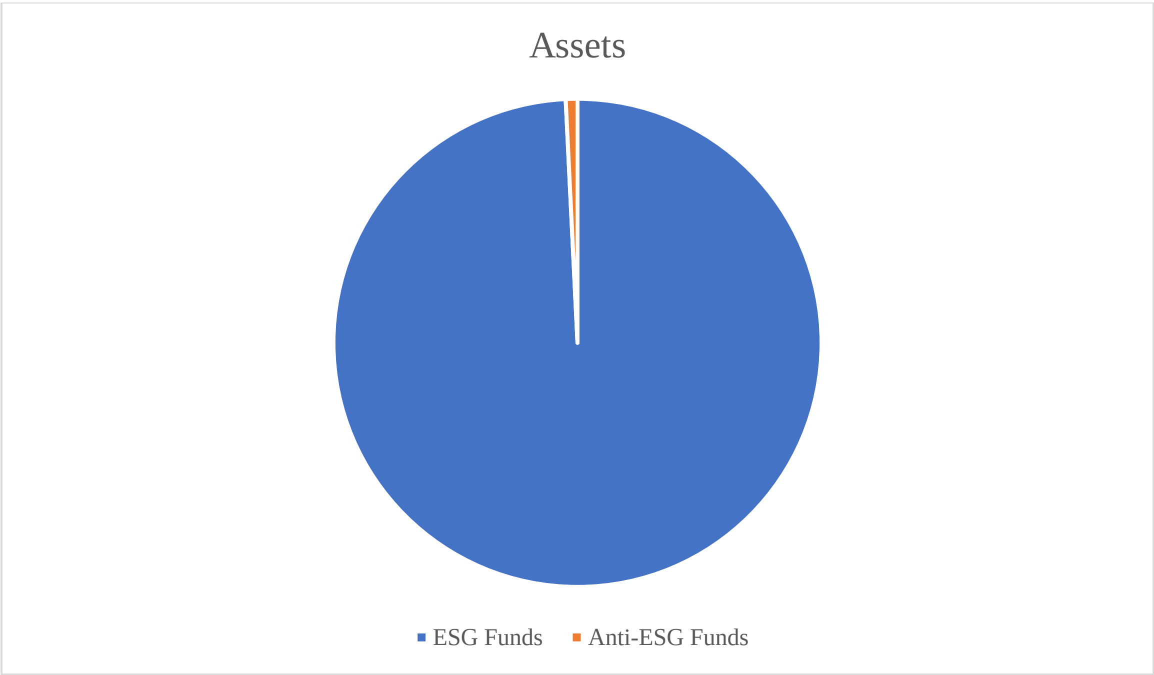
13 Rachel Layne, *As Climate Fears Mount, More Investors Turn to "ESG" Funds Despite Few Rules*, Harvard Business School (Mar. 23, 2023), https://hbswk.hbs.edu/item/as-climate-fears-mount-more-investors-turn-to-esg-funds-despite-few-rules.

14 U.S. Sustainable Investment Forum, *Sustainable Investing Basics*, https://www.ussif.org/sribasics.

15 *How Sustainability is Transforming the Economy and Creating Opportunities for Investors*, supra note 11.

Morningstar reports that sales of anti-ESG funds peaked at $377 million in the third quarter of 2022. Since that time, sales plunged to $188 million in the last quarter of 2022 and $183 million in the first quarter of 2023. The number of ESG funds also dwarfs that of anti-ESG funds. As noted above, there are hundreds of ESG investment vehicles. But Morningstar counted only 27 funds that it classified as anti-ESG. One anti-ESG fund launched in May 2022, picked up $870,000 on average in each quarter since, and filed for liquidation on June 2, 2023.

Overall, ESG funds outpace anti-ESG funds by nearly $270 billion to $2.1 billion.[16]



ESG Investments Offer Significant Financial Returns

A common refrain from those that oppose ESG investing and that promote anti-ESG funds is that sustainable investing means that financial results are forgone in order to achieve sustainable outcomes. But research shows that this assertion is not true. Rather, ESG and future profitability are linked. In other words, sustainable investing is not just about investing in companies that promote the best environmental, societal, and governance outcomes. Instead, looking at the investment universe through an ESG lens gives investors a comprehensive framework for how to identify companies that are best positioned for long-term profitability.

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16 Joe Morris, *Anti-ESG Funds fail to gain traction in the US*, Financial Times (June 20, 2023), https://www.ft.com/content/e031fc3c-524b-4284-865f-e9849d424b02; Ross Kerber, *"Anti-ESG" funds face slowing deposits, Morningstar says*, Reuters (June 9, 2023), https://www.reuters.com/sustainability/anti-esg-funds-face-slowing-deposits-morningstar-says-2023-06-08/; David Hood and Yun Park, *Anti-ESG Funds Growing, Fail to Draw Major Investor Interest*, Bloomberg Law (June 9, 2023), https://news.bloomberglaw.com/esg/anti-esg-funds-slow-to-gain-major-investor-interest-report-says; Alyssa Stankiewicz and Mahi Roy, *The Anti-ESG Fad Might Be Over Before It Got Going*, Morningstar (June 7, 2023), https://www.morningstar.com/sustainable-investing/anti-esg-fad-might-be-over-before-it-got-going.

The reason for this advantage should be clear. The overwhelming scientific consensus is that climate change represents a potentially catastrophic threat and that the effort to combat climate change will lead to transformational change in all sectors of our society. In the face of these inevitable, pervasive, and powerful forces, it's easy to spot the smart investment: companies that are better prepared to deal with the impact of climate change and to compete in a decarbonized economy will likely be safer and better investments than companies that are not. So while many investors care about ESG issues because they want to advance policy goals, they also understand that companies that take the ESG factors seriously offer better financial returns.

To use environmental factors as an example, a company's strong environmental policies could have long-term benefits for their bottom line as it works towards thriving in a post-transition economy. Despite the assumption that companies that disregard environmental practices have lower overhead costs, research shows that ESG characteristics and profitability are linked. For example, companies that occupy LEED certified buildings tend to use less power, use renewable materials, and incorporate better construction methods in their buildings. Overall energy efficiency translates to lower operating costs. So occupying LEED certified buildings not only has a meaningful impact on building emissions but also leads to higher gross profitability and higher expected returns. The bottom line is that investors don't have to make performance concessions to achieve sustainable outcomes. ESG data is an indicator of future performance potential and should be incorporated into investors' decision-making. In other words, sustainability and financial profitability are inextricably linked.[17]

These sentiments come from the industry itself. Investment firms recognize that companies that transition successfully will be best positioned for success in the new sustainable economy. They argue that, for investors, this is not an impact bet but an understanding of where the economy is going. Investments that help accelerate the transition therefore have the potential to provide attractive financial returns.[18] For example, Goldman Sachs Global Investment Research found that stocks scoring higher for environmental and social criteria performed better than lower-scoring stocks for the first 11 months of 2022. This continued a trend stretching back more than a decade: in a study going back to the start of 2012, the lowest-ranking group of companies based on environmental and social criteria consistently underperformed the higher-ranking groups.[19] Indeed, since its establishment in 2019, the S&P Global 500 ESG Index has roughly tracked the standard S&P 500 Index, slightly outperforming it since 2020.[20]

Data from Morningstar has also found that sustainable investing generates returns similar to or better than those of the overall market. The broad Morningstar US Sustainability Index fell 18.9

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17 Blackrock, *ESG X Big Data: Solving for the Double Bottom Line* (May 12, 2023), https://www.blackrock.com/us/individual/insights/decoding-the-markets-esg-x-big-data.

18 *How Sustainability is Transforming the Economy and Creating Opportunities for Investors*, supra note 11.

19 *Id*.

20 Karin Rives, *A "fiduciary question' looms large over the ESG debate in 2023*, S&P Global Market Intelligence (Jan. 26, 2023, https://www.spglobal.com/marketintelligence/en/news-insights/latest-news-headlines/a-fiduciary-question-looms-large-over-the-esg-debate-in-2023-73830569.

percent in 2022, outperforming the 19.5% decline of its parent, the Morningstar US Large Mid-Cap Index. In the same period, the S&P 500 fell 19.4%.

Similarly, according to Morningstar's 2022 Sustainable Funds US Landscape Report, in 2021, most sustainable funds delivered stronger total and risk-adjusted returns than their respective Morningstar Category indexes. Slightly more than half of sustainable funds finished in the top half of their Morningstar category. Data for the previous five years showed even better results, as the returns of 74% ranked in the top half and 49% ranked in the top quartile returns.

In 2021, the Morgan Stanley Institute for Sustainable Investing found that in a year of extreme volatility, funds focused on environmental, social, and governance factors weathered the year better than non-ESG portfolios. The research analyzed more than 3,000 US mutual funds and ETFs, finding that sustainable equity funds outperformed non-ESG peers by a median total return of 4.3% in 2020. Meanwhile, sustainable taxable bond funds over the same period outperformed their peers by a median total return of 0.9%. In 2019, both sustainable equity funds and sustainable taxable bond funds also outperformed their traditional peer funds.[21]

Similarly, a 2019 white paper produced by the Morgan Stanley Institute for Sustainable Investing compared the performance of sustainable funds with traditional funds and found that, from 2014 to 2018, the total returns of sustainable mutual and exchange traded funds were similar to those of traditional funds. The study concluded that there is no financial trade-off in the returns of sustainable funds compared to traditional funds. The Morgan Stanley study also found that sustainable funds consistently showed a lower downside risk than traditional funds, regardless of asset class. The study found that during turbulent markets, such as in 2008, 2009, 2015, and 2018, traditional funds had significantly larger downside deviation than sustainable funds, meaning traditional funds had a higher potential for loss.

Finally, JUST Capital ranks companies based on factors such as whether they pay fair wages or take steps to protect the environment. It created the JUST U.S. Large Cap Diversified Index (JULCD), which includes the top 50% of companies in the Russell 1000 (a large-cap stock index) based on those rankings. Since its inception, the index has returned 15.94% on an annualized basis compared with the Russell 1000's 14.76% return.[22]

SEC Proposals

Investor demand for ESG investments coupled with the strong returns such investments offer means that investors need to know where companies stand on the ESG criteria and what investments incorporate ESG investing. One barrier to the continued growth of ESG investing is the lack of consistent reporting standards for ESG data.[23] Indeed, investors are increasingly demanding

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21 *Sustainable Investing Basics*, supra note 14.

22 *Id.*; *ESG for Beginners*, supra note 3.

23 Brad Foster and David Tabit, *As demand for ESG investing grows, so too does the need for high-quality data*, Bloomberg (Apr. 22, 2019), https://www.bloomberg.com/professional/blog/demand-esg-investing-grows-need-high-quality-data/.

comprehensive, comparable, and reliable data related to ESG.[24] Fortunately, the SEC has proposed three rules that aim to provide investors with precisely that information.

First, the SEC has proposed a rule that would establish a mandatory disclosure regime for registrants in response to broad investor demand for better disclosure about how the companies they own are responding to the financial risks and opportunities presented by climate change. The rule would require that registrants disclose a variety of relevant data and information on their climate-related risks, metrics to assess climate-related risks, and strategies for addressing climate-related risks. If adopted, the rule would enhance the transparency of registrants' actions related to climate change, to the benefit of investors who are entitled to decision-useful information about how the companies they invest their money in are responding to one of the most urgent economic and financial risks our society faces.[25]

Second, the SEC has proposed a rule that would require investment companies, investment advisers, and other entities to disclose to investors information regarding their ESG investment strategies. The rule would establish a standardized ESG disclosure framework that would create more reliable, consistent, and comparable disclosures for ESG funds based on the extent to which a fund considers ESG factors in its investment selection and issuer engagement processes. If adopted, the rule would assist retail and institutional investors and satisfy growing investor demand for material information that can guide their investment decisions and protect them from misleading and abusive claims surrounding ESG investment strategies.[26]

Third, the SEC has proposed a rule that would ensure that the name of a registered investment company or business development company is not materially deceptive or misleading. The rule would strengthen the existing fund names rule and require that funds whose name suggests a focus on particular characteristics invest at least 80% of their assets in the type of investment suggested by their name. The rule uses the example of funds that indicate incorporation of one or more ESG factors in its investment selection process. The inclusion of terms such as "ESG" and "Sustainable" in fund names can lead to hundreds of millions of dollars of net flow to a fund. As a result, the rule would ensure that investors are not misled by a fund's name.[27]

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[24] *ESG: Trends to Watch in 2023*, supra note 7; James Killerlane, *How Issuers and Investors Can Find Common Ground on ESG*, Harvard Law School Forum on Corporate Governance (July 12, 2022), https://corpgov.law.harvard.edu/2022/07/12/how-issuers-and-investors-can-find-common-ground-on-esg/.

[25] *See* The Enhancement and Standardization of Climate-Related Disclosures for Investors, 87 Fed. Reg. 21,334 (Apr. 11, 2022); Better Markets, Comment Letter on The Enhancement and Standardization of Climate-Related Disclosures for Investors (June 17, 2022), https://bettermarkets.org/wp-content/uploads/2022/06/Better_Markets_Comment_Letter_Enhancement_Standardization_Climate_Related_Disclosures.pdf.

[26] *See* Enhanced Disclosures by Certain Investment Advisers and Investment Companies about Environmental, Social, and Governance Investment Practices, 87 Fed. Reg. 36,654 (June 17, 2022); Better Markets, Comment Letter on Enhanced Disclosures by Certain Investment Advisers and Investment Companies about Environmental, Social, and Governance Investment Practices (Aug. 16, 2022), https://bettermarkets.org/wp-content/uploads/2022/08/Better_Markets_Comment_Letter_ESG_Disclosures.pdf.

[27] *See* Investment Company Names, 87 Fed. Reg. 36,594 (June 17, 2022); Better Markets, Comment Letter on Investment Company Names (Aug. 16, 2022), https://bettermarkets.org/wp-content/uploads/2022/08/Better_Markets_Comment_Letter_SEC_Investment_Company_Names.pdf.

The adoption of these three rule proposals would ensure that, along with their demand for ESG-related products, investors receive the information about the ESG factors that they need.

Conclusion

When it comes to ESG, the market has spoken. Investors want to invest in ESG investments, and businesses are satisfying that demand. Businesses and investors know that ESG is not simply about values; rather, it is about maximizing returns in a changing economy.

Indeed, the only thing that might prevent businesses and investors from realizing those returns is interference from legislators that normally favor free market solutions to societal problems.[28] Legislators have proposed a number of bills that aim to restrict fund managers' ability to consider ESG factors when making investments. Unsurprisingly, business leaders oppose these efforts. Recently, 270 businesses, banks, advocacy groups, and public retirement funds signed a "Freedom to Invest" initiative. The signatories urged federal and state lawmakers to protect their fiduciary duties and ability to make investment decisions that best serve their shareholders and beneficiaries for the long term. In addition to the California State Teachers Retirement System and the New York State Common Retirement Fund—two of the nation's largest pension programs—signatories included Boston Walden Trust Co., Trillium Investments LLC, and Franklin Templeton, as well as several other financial firms.[29]

The reason is that businesses recognize the importance of ESG. In 2022, Bloomberg conducted a study of global business leaders and found that the top motivation for considering ESG investing was the possibility of greater returns. And 71% of non-ESG fund managers said ESG was an important consideration when making investment decisions. Perhaps most significantly, 71% of all global business leaders said that, eventually, no investment decisions will be made without considering ESG.[30] It's fair to say that ESG investing is here to stay.

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28 Maxine Joselow, *Some businesses say anti-ESG bills are anti-free market*, Wash. Post (June 22, 2023), https://www.washingtonpost.com/politics/2023/06/22/some-businesses-say-anti-esg-bills-are-anti-free-market/

29 Karin Rives, *270 companies, major pension funds join pro-ESG "Freedom to Invest" campaign*, S&P Global Market Intelligence (Mar. 20, 2023), https://www.spglobal.com/marketintelligence/en/news-insights/latest-news-headlines/270-companies-major-pension-funds-join-pro-esg-freedom-to-invest-campaign-74862666.

30 Bloomberg, *The Future of ESG Investing*, https://sponsored.bloomberg.com/article/mubadala/the-future-of-esg-Investing?sref=mQvUqJZj.

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