Go deeper

Taking client relationships to the next level.

JANUARY 2018 EATON VANCE ADVISOR INSTITUTE

Responsible Investing is good business

Imagine how your business could change and grow if you were to implement an approach that:

- Attracts the emerging wealth of millennials and Generation X
- Connects meaningfully with women investors
- Appeals to ultra-high-net-worth families
- Sharpens identification of possible networking events in your community
- Differentiates your brand
- Provides a unique bridge to referrals
- Expands multigenerational planning conversations

Incorporating Responsible Investing into your practice can provide new opportunities to connect with clients and prospective clients about the issues that matter most to them.

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This Advisor Institute primer will help you become more comfortable and confident in discussing Responsible Investing with clients and incorporating it into your practice. We will address four essential questions:

1. **How do advisors and various investor demographics perceive Responsible Investing?**
2. **What is Responsible Investing?**
3. **What are various approaches to investing responsibly?**
4. **How can Responsible Investing enhance your practice?**

This primer also explores some empirical research on the relationship between Responsible Investing and performance.

1. How do advisors and various investor demographics perceive Responsible Investing?

As an advisor, when you hear the phrase "Responsible Investing" do any of these terms come to mind?

TREE-HUGGER
Do-gooder
Social activism
Limousine liberal
Radical
GRANOLA
Save the whales
Socially conscious

This isn't entirely unfair since this type of investing began with the various activist movements of the 1960s and 1970s: Civil Rights, feminism, consumer protection, anti-war, environmental and anti-Apartheid movements all sought to influence corporate behavior by threatening stock price performance.

Investment managers, in turn, sought to reduce reputational and investment risk by avoiding companies in the crosshairs of activists.

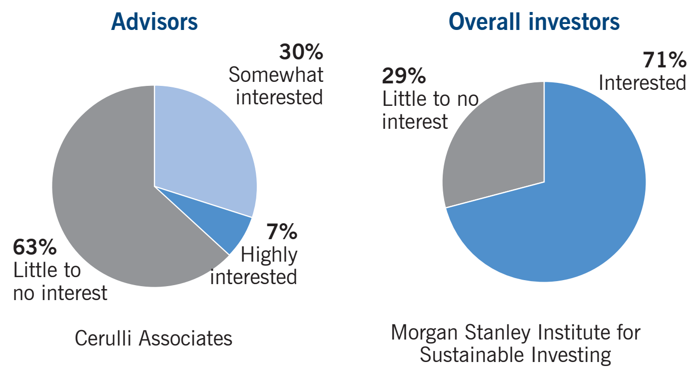
But it turns out that investors and advisors have differing perceptions.

What do the demographics tell us?

A 2015 Cerulli survey found that 63% of advisors have little or no interest in sustainable investing, but a significant majority of investors (according to the Morgan Stanley Institute for Sustainable Investing) are interested (Exhibit A). If you're not discussing this topic with your clients, are you at risk of losing those relationships to other advisors who will?

While many advisors have avoided Responsible Investing due to preconceived notions about its effect on portfolio performance, investor interest has grown significantly.

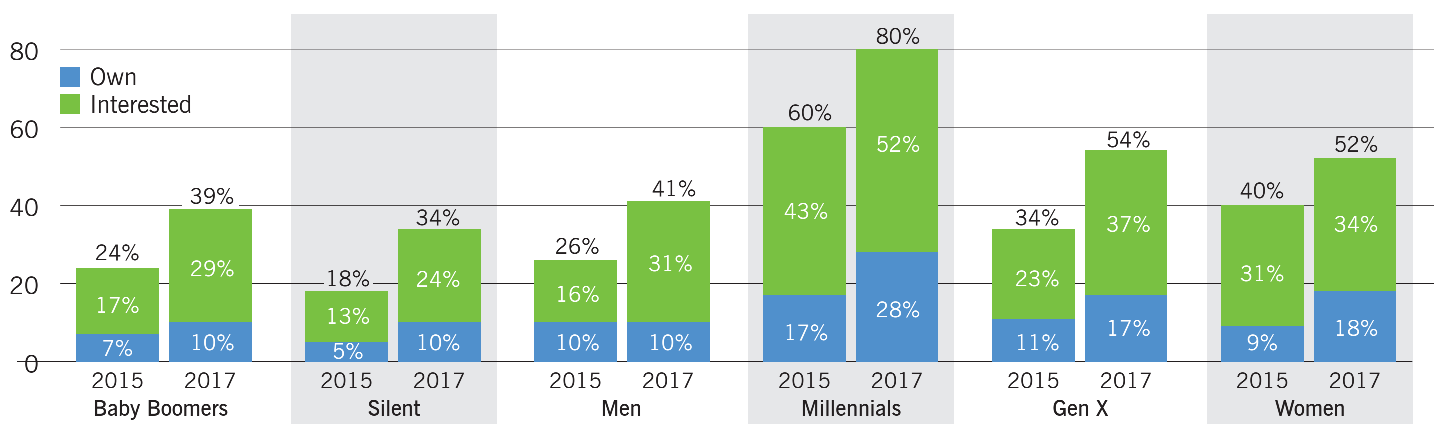
Exhibit A **Majority of advisors have limited interest in sustainable investing.**



Source: ThinkAdvisor, December 28, 2015. "The Growing Influence of Impact Investing."

The detailed findings of the 2017 U.S. Trust Insights on Wealth and Worth® Survey noted that across various demographic groups, an increasing percentage of investors own or are interested in impact investments (Exhibit B).

Exhibit B **Millennials, Gen X and women lead the way for Responsible Investing.**
Percent who own or are interested in impact investments



Source: 2017 U.S. Trust Insights on Wealth and Worth® Survey, based on a nationwide survey of 808 high-net worth adults.

2. What is Responsible Investing?

Investing with regard to factors over and above financial returns has long been known as "SRI" (socially responsible investing), but today is more frequently called "sustainable" or "ESG" (environmental, social and governance) investing. This is because the development of ESG research standards has made it easier for investors and advisors to evaluate companies on these factors, and to tailor portfolio content to align with particular beliefs and values.

There are many other terms associated with Responsible Investing (see blue box below). For simplicity, we will call all of these "Responsible Investing," which the UN Principles for Responsible Investment defines as:

> *"an approach to investing that aims to incorporate environmental, social and governance (ESG) factors into investment decisions, to better manage risk and generate sustainable, long-term returns."* [1]

Adoption of these principles is growing rapidly. Since 2006, more than 1,700 investment managers and more than 340 "asset owners" (pensions, foundations, etc.) worldwide, representing over $68 trillion in assets, have become signatories of this leading proponent for responsible investment.[2]

The language of Responsible Investing

- **Sustainable:** Meeting present needs without compromising future abilities
- **Values-based:** Typically exclusionary based on policies, products, actions, services
- **Green:** Environmental focus (clean air and water, resource stewardship)
- **Ethical:** Guided by moral values, ethical codes, or religious beliefs
- **Mission-related:** Emphasis on selecting companies advancing a common mission
- **SRI:** Socially responsible investing – social, environmental, financial
- **ESG:** Environmental, social and corporate governance
- **CFP:** Corporate financial performance, a mix of market-based and accounting-based measures generally considered by financial analysts when assessing the investment attractiveness of a security
- **CSR:** Corporate social responsibility, a ranking system that has gradually evolved into ESG
- **Social screening:** Eliminating companies from consideration based on activities
- **Impact:** Highly focused investment to accomplish a specific purpose

These terms represent general understandings and applications and are not necessarily definitive reflections of how these values or terms are applied everywhere.

There is also much more information available today than there was just a few years ago. The percentage of S&P 500 companies reporting on their sustainability efforts has increased from just 20% in 2011 to 82% in 2016.[3]

Research dispels common perceptions

When reviewing the growing body of academic research on the association between responsible practices and performance, we don't (yet) expect to find conclusive proof that Responsible Investing leads to better investment performance. Instead, we consider whether they offer a compelling counterargument to a lingering perception in our industry that Responsible Investing can lead to investment losses.

Do companies that address ESG concerns generate more positive results?

Although some research already points to these trends, it makes sense that implementation of sustainable business practices can create efficiencies that increase shareholder value and mitigate risk. For example, initiatives to reduce and reuse waste, improve energy efficiency or conserve natural resources can produce savings that flow to a company's bottom line. Likewise, companies with strong governance may potentially avoid costly workforce problems, negative publicity and regulatory sanctions.

Does Responsible Investing sacrifice performance?

The most exhaustive research analysis[4] on this question looked at about 2,200 individual studies from the 1970s through 2014. These studies relate environmental, social and governance (ESG) performance to corporate financial performance (CFP), which includes market-based and accounting-based measures that equity analysts frequently use to measure the relative investment attractiveness of companies.

The authors found "evidence for the business case for ESG investing." They noted that "this finding contrasts with the common perception among investors." They also found that "ESG outperformance opportunities exist in many areas of the market," not just equities, noting that "this [also] holds true for North America, emerging markets and nonequity asset classes."

Why do companies address ESG?

A 2015 Oxford University review[5] of over 200 academic and other studies found that "90% of the cost of capital studies show that sound ESG standards lower the cost of capital." In addition, "88% of the studies show that solid ESG practices result in better operational performance" and "80% of the studies show that stock price performance is positively influenced by good sustainability practices."

Can ESG factors affect company and portfolio performance?

A CFA Institute review of a study[6] in the Journal of Investing found that although "concerns persist that reducing an investment universe negatively affects portfolio construction and returns," analysis of the research shows that "there is a positive effect when excluding poorly ranked ESG companies from a universe. This study should help alleviate concerns that ESG investing necessitates a performance cost."

Responsible Investing enters the mainstream

Responsible Investing is not a "new age" phenomenon, but a well-established and growing investment choice:

- $8.72 trillion in assets in the U.S.*
- $1 of every $5 under professional management in the U.S.*
- Over 1,300 ESG strategies in the U.S.*
- Globally, over 11,000 public companies report on ESG factors**

*US SIF Foundation. Report on US Sustainable, Responsible and Impact Investing Trends 2016. **Bloomberg Impact Report Update (2015).

3. What are various approaches to investing responsibly?

There are several investment approaches that can bring Responsible Investing into your practice, and we can categorize them broadly as passive, active and benevolent.

Return expectations and the level of involvement will vary depending on a client's priorities (Exhibit C). Investors can invest anywhere on the continuum, from avoidance (least involvement) to engagement (most involvement).

Avoidance involves excluding companies by screening them out of the investable universe. Engagement is the opposite approach – seeking to own companies for the express purpose of influencing management and improving their practices.

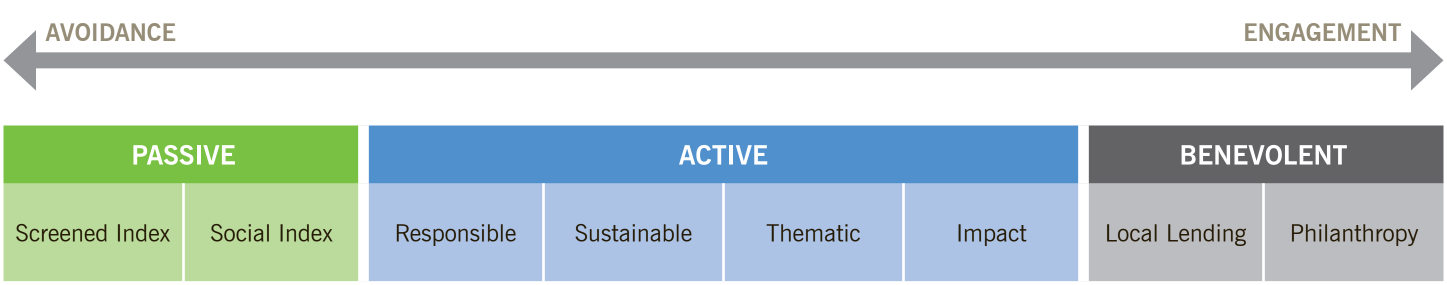
The middle ground is generally a combination of the two approaches, possibly screening out some industries entirely (such as tobacco or alcohol) and selecting the best companies within the remaining industry subsectors with an eye toward influencing management to behave even better. This can also take the form of advocacy of particular issues, typically by filing shareholder resolutions with management.

Let's take a closer look at these three approaches.

Passive

Not surprisingly, passive strategies are particularly appropriate for investors who wish to take an avoidance approach to Responsible Investing. This is because excluding a list of companies still leaves a large investable universe from which to construct an index portfolio. Passive Responsible Investing falls into two main camps:

Exhibit C **Continuum of Responsible Investing.**



The continuum above was developed by Eaton Vance for illustrative purposes with information sourced from US SIF Foundation's Report on US Sustainable, Responsible and Impact Investing Trends 2016.

- **Screened Index:** Takes standard indexes (such as the S&P 500, Russell 3000, etc.) and excludes securities in certain industries or companies that participate in activities deemed unacceptable by the client.
- **Social Index:** Utilizes proprietary indexes (KLD 400, MSCI ESG, etc.) that are constructed to replicate a specific ESG universe.

Passive approaches are popular for investors who tend to measure their performance against benchmarks like the S&P 500 Index or the Russell 3000 Index. They allow for very precise tailoring of the content of a portfolio, while permitting replacement of screened names from a broad universe of other nonoffending names. There are several screening methodologies, but the most common ones reject companies deriving more than a threshold percentage of revenue (5% and 10% are common thresholds) from a particular activity or companies meeting a particular numerical threshold (such as the number of women on the board of directors).

Clients whose portfolio holdings may become public knowledge (foundations, for example, or celebrities with a public platform in support of a cause) can ensure that the content of their portfolios is consistent with their stated beliefs and values – without sacrificing performance.

Active

Active Responsible Investing generally falls into four main classifications. The classifications and their definitions may vary from one investment advisor to another, but here is a general guide:

- **Responsible** portfolios generally screen out offenders from their investment universe before selecting individual stocks for the portfolio. These portfolios consider ESG risk and/or client values across a range of factors to screen out investments.
- **Sustainable** portfolios operate a little differently, choosing an ESG investment universe first and then selecting the anticipated top performers in that universe to construct a portfolio. They target investments best positioned to benefit from integration of ESG factors and broad macro trends.
- **Thematic** portfolios are more like sector funds that focus on specific ESG themes, like gender diversity or clean energy use. They focus on areas where environmental or social needs offer opportunities to achieve market-like returns.
- **Impact** portfolios target very specific social or environmental goals in full expectation of divergent (and possibly disappointing) investment returns. These portfolios emphasize the optimization of environmental or social needs, which may result in a financial trade-off.

Active management gives investors an avenue for real engagement, because shareholders have rights that nonshareholders do not. Investors seeking a voice within already-good companies (that *could* be great) may prefer active management, as professional investment managers must still be good stewards of capital.

As fundamental analysts, many active managers look carefully at the financial materiality of ESG factors in a company's work. Financial materiality recognizes that some goals simply are not relevant in a material way to certain industries. Evaluating financial companies, for example, on their commitment to environmental standards like biodiversity and hazardous material management would make little sense, as these issues are entirely tangential to the business activities of financial companies and unlikely to connect in any way to revenue, operating expenses and so on.

Benevolent

Benevolent strategies, which fall into two main classifications, are focused on effecting positive change and offer little or no expectation of investment return.

- **Local Lending** allows wealthy investors to finance projects in expectation of receiving their principal back, such as funding an arts cooperative that refurbishes an abandoned warehouse and provides a kiln for pottery that will be sold. Proceeds from craft sales would eventually repay the loan.
- **Philanthropy**, on the other hand, allows precise control of how invested dollars are deployed, but absolutely no expectation of financial return other than an income tax deduction.

Community foundations and highly focused foundations are common benevolent vehicles, and wealthy clients often derive enormous satisfaction from enriching their communities or supporting local causes with little or no expectation of financial reward.

4. How can Responsible Investing enhance your practice?

Responsible Investing disproportionately resonates with wealthy families, women, Gen X and millennials. Understanding Responsible Investing can help you focus your networking activities, sharpen your brand differentiation, capture referable moments and expand the opportunities to connect to the next generation of clients.

Networking

We have always believed in one fundamental principle: It is better to be discovered than announced. So much of your success in attracting new clients is a function of your visibility within the community. How much better is it to meet a wealthy prospective client socially rather than "cold call" her to solicit business?

Where should you go to be discovered? We suggest you start by identifying a list of causes that you, your family, your friends and your clients hold dear. See the passion identification worksheet at the end of this primer for guidance.

Top 10 causes for wealthy investors

- Environmental protection and sustainability
- Health care quality and access
- Disease prevention, treatment or cure
- Access to education
- Veterans assistance
- Children and youth development
- Elder care protection and well-being
- Social mobility
- Religious values and doctrine
- Advancement and empowerment of women

Source: U.S Trust, 2016 U.S. Trust Insights on Wealth and Worth Survey, Key Findings, pp. 37-39.

Suppose, for example, you have an interest in the importance of clean water and attend a fundraiser locally to learn about how you can get more involved in the cause. You make some wonderful first encounters. Perhaps a follow-up call could sound like this:

> "I was reflecting on our conversation at the Clean Water fundraiser last week and thought it made sense to give you a call. Certainly, I didn't want to discuss business at this wonderful event, but was struck by your passion. Our family also has a deep passion for the importance of clean water and a variety of other environmental concerns. In fact, our commitment to our planet has shaped how we approach our financial advisory practice. Did you realize there are ways to invest that can align with your interest in clean water?"

This approach is genuine and shows concern for what matters most to the prospective client.

Workshops

According to the detailed findings of the 2017 U.S. Trust Insights on Wealth and Worth® Survey, high-net-worth (HNW) investors give back in the following ways:

- Seventy-four percent give financially to nonprofits
- Sixty-nine percent volunteer time, skills, services
- Twenty-seven percent serve on a board of a nonprofit

Yet, only 13% own responsible investments. Why only 13%?

The same survey results indicate that, although overall use of impact investments has remained flat, interest among HNW investors continues to rise. In 2017, 32% of HNW investors were interested in impact investments – up from 22% in 2015. Could the gap between "interest" and "owning" be as simple as not knowing how to move forward?

One way to close the gap is to host Responsible Investing workshops for clients and prospective clients, perhaps over a Saturday morning brunch at a local restaurant.

Brand differentiation

Perhaps it is precisely this gap that has led many successful advisors to embrace Responsible Investing as a cornerstone of their practices as well as a key point of differentiation.

To make Responsible Investing a part of your story, consider your fundamental beliefs, or what we refer to as your “isms” (short for aphorisms, or rules of thumb). You may have investment isms, planning isms or estate planning isms. What isms are at the absolute core of your beliefs? Could it be time to add an ism about Responsible Investing? The title of this primer can be your inspiration.

Capturing today's referable moments

Your isms can also help bring you into conversations that take place between your clients and their friends when you are not in the room.

Suppose your client is at lunch with a friend and the topic of corporate mismanagement comes up. Your client might respond with an ism she heard from you, such as "Responsible Investing is just good business" (a variation of this primer's title). Your client's lunch companion is likely to ask for clarification of that short, pithy statement of belief. In the discussion that follows, your client has the opportunity not only to look well-informed on the topic but also to reveal the source of her information: YOU.

Connecting to the next generation

You certainly don’t need to read one more white paper to appreciate the challenges today’s advisors face in connecting to the next generation of their clients. But seriously embracing Responsible Investing might help. As the survey results referenced earlier in this primer clearly suggest, millennials, Gen X and women have a significant and growing interest in Responsible Investing.

Suppose Responsible Investing is embedded within your practice and you happen to find out that Cathy and William’s daughter, JoAnn, has a significant passion for animal rights initiatives. Perhaps you suggest that they ask JoAnn: “Do you realize there are ways that your investments can mirror your animal rights passions?” It just might lead to a discussion about you.

Another important way to connect to the various generations of client families is to host family retreats that focus on crafting and activating family mission statements. This type of activity tends to take on added meaning for families when causes, and often specific organizations, have been identified that align wonderfully with Responsible Investing priorities.

Final thought

The investment landscape of Responsible Investing is positioned on extremely fertile ground with the likelihood that interest will continue to blossom in the years ahead. Could Responsible Investing become a differentiator for your practice?

Keep the conversation going

Learn more about building bridges to referrals, going deeper with client conversations and working with the next generation. Visit The Advisor Institute Coach's Corner at **eatonvance.com**.

For a complimentary copy of "Client Primacy: Inspiring Intentional Outcomes," by David Richman and Alan Parisse, please contact your Eaton Vance representative or call **800-836-2414**.

ENDNOTES

[1]Principles of Responsible Investment (PRI), https://www.unpri.org/about/what-is-responsible-investment.

[2]Principles of Responsible Investment (PRI), https://www.unpri.org/about.

[3]Governance & Accountability Institute Inc., "FLASH REPORT: 82% of the S&P 500 Companies Published Corporate Sustainability Reports in 2016," May 31, 2017.

[4]Friede, Gunnar, Busch, Timo, and Bassen, Alexander (2015). "ESG and financial performance: aggregated evidence from more than 2000 empirical studies." Journal of Sustainable Finance & Investment, Vol. 5, Issue 4, pages 210-233, http://dx.doi.org/10.1080/20430795.2015.1118917 accessed January 27, 2017.

[5]Clark, Gordon L., Feiner, Andreas, and Viehs, Michael (2015). "From the Stockholder to the Stakeholder: How Sustainability Can Drive Financial Outperformance." SSRN abstract 2508281.

[6]De, Indrani and Clayman, Michelle (Winter 2015). "The benefits of socially responsible investing: an active manager's perspective (Digest Summary)." CFA Digest, Vol. 46, Issue 6, http://www.cfapubs.org/doi/full/10.2469/dig.v46.n6.6 accessed March 17, 2017.

Passion identification worksheet

These are the United Nations' 17 Sustainable Development Goals, and you can start almost any discussion of Responsible Investing with one of these. Start by identifying the causes you are most passionate about – then identify the causes that your friends, family and clients are passionate about. This worksheet can help you identify where there is a shared interest.

	Cause	You	Friends and family	Clients
1 NO POVERTY	**No poverty** End poverty in all its forms everywhere.			
2 ZERO HUNGER	**Zero hunger** End hunger, achieve food security and improved nutrition, and promote sustainable agriculture.			
3 GOOD HEALTH AND WELL-BEING	**Good health and well-being** Ensure healthy lives and promote well-being for everyone at all ages.			
4 QUALITY EDUCATION	**Quality education** Ensure inclusive and quality education for all and promote lifelong learning.			
5 GENDER EQUALITY	**Gender equality** Achieve gender equality and empower all women and girls.			
6 CLEAN WATER AND SANITATION	**Clean water and sanitation** Ensure access to water and sanitation for all.			
7 AFFORDABLE AND CLEAN ENERGY	**Affordable and clean energy** Ensure access to affordable, reliable, sustainable and modern energy for all.			

	Cause	You	Friends and family	Clients
8 DECENT WORK AND ECONOMIC GROWTH	**Decent work and economic growth** Promote inclusive and sustainable economic growth, employment and decent work for all.			
9 INDUSTRY, INNOVATION AND INFRASTRUCTURE	**Industry, innovation and infrastructure** Build resilient infrastructure, promote sustainable industrialization and foster innovation.			
10 REDUCED INEQUALITIES	**Reduced inequalities** Reduce inequalities within and among countries.			
11 SUSTAINABLE CITIES AND COMMUNITIES	**Sustainable cities and communities** Make cities inclusive, safe, resilient and sustainable.			
12 RESPONSIBLE CONSUMPTION AND PRODUCTION	**Responsible consumption and production** Ensure sustainable production and consumption patterns.			
13 CLIMATE ACTION	**Climate action** Take urgent action to combat climate change and its impacts.			
14 LIFE BELOW WATER	**Life below water** Conserve and sustainably use the oceans, seas and marine resources.			
15 LIFE ON LAND	**Life on land** Sustainably manage forests, combat desertification, halt and reverse land degradation, halt biodiversity loss.			
16 PEACE, JUSTICE AND STRONG INSTITUTIONS	**Peace, justice and strong institutions** Promote just, peaceful and inclusive societies.			
17 PARTNERSHIPS FOR THE GOALS	**Partnerships for the goals** Revitalize the global partnership for sustainable development.			

Source: United Nations Sustainable Development Goals (2016): http://www.un.org/sustainabledevelopment/sustainable-development-goals/.

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Investing entails risk, including possible loss of principal.

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