


INVESTOR INSIGHTS SERIES

Mind shift

Getting past the screens of responsible investing

Think environmental, social and governance (ESG) is all about excluding sin stocks from portfolios? Think again. Incorporating ESG goes well beyond the old one-dimensional negative screens of socially responsible investing (SRI) in seeking to proactively manage portfolio risk and identify new investment opportunity.

Environmental, social and governance issues have come to the fore of market news in recent years, presenting a challenge for investors that reaches well beyond functions of screening out undesirable securities to include fundamental questions about the risk profiles and return potential of their portfolios.

The 2015 discovery of an emissions testing scandal at Volkswagen may be a prime example of how these issues affect investors. In the wake of an ethical scandal that reached the highest executive levels of the world's largest car manufacturer, the firm was left with $18.6 billion in fines and restitution to customers, the potential economic impact of a tarnished brand and a rapid 50% decline in stock value.

Investors globally want their investments to reflect their personal values, going as far in the U.S. as to say access to investments that incorporate ESG may actually increase retirement plan participation.[1]

Professional investors say ESG is likely to become a standard practice, but are looking for stronger tools for measuring performance on ESG factors.[2]

ESG investing focuses on investments in companies that relate to certain sustainable development themes and demonstrate adherence to environmental, social and governance (ESG) practices, therefore the universe of investments may be reduced. A security may be sold when it could be disadvantageous to do so or forgo opportunities in certain companies, industries, sectors or countries. This could have a negative impact on performance depending on whether such investments are in or out of favor.

1 Natixis Global Asset Management, Survey of U.S. Defined Contribution Plan Participants conducted by CoreData Research, August 2016. Survey included 951 U.S. workers, 651 being plan participants and 300 being non-participants.

2 Natixis Global Asset Management, Global Survey of Institutional Investors conducted by CoreData Research in October and November 2016. Survey included 500 institutional investors in 31 countries.

Over the past year we have tracked sentiment on ESG across three different investor populations to get a fix on how both professional and individual investors look at its role and impact. What we found in the responses from institutional decision makers, financial advisors and individual investors globally and defined contribution plan participants in the U.S. was a distinct split in the views of professionals and individuals that challenges conventional thinking about ESG.

In short, we find that individuals believe considerations about the environmental, social and ethical records of the companies in which they invest are important. The professionals at institutions and within the investment community are more skeptical about the efficacy of these strategies, citing concerns about performance measurement. The real disconnect between the two populations may be based more on semantics than impact on investment performance.

The yin and yang of ESG

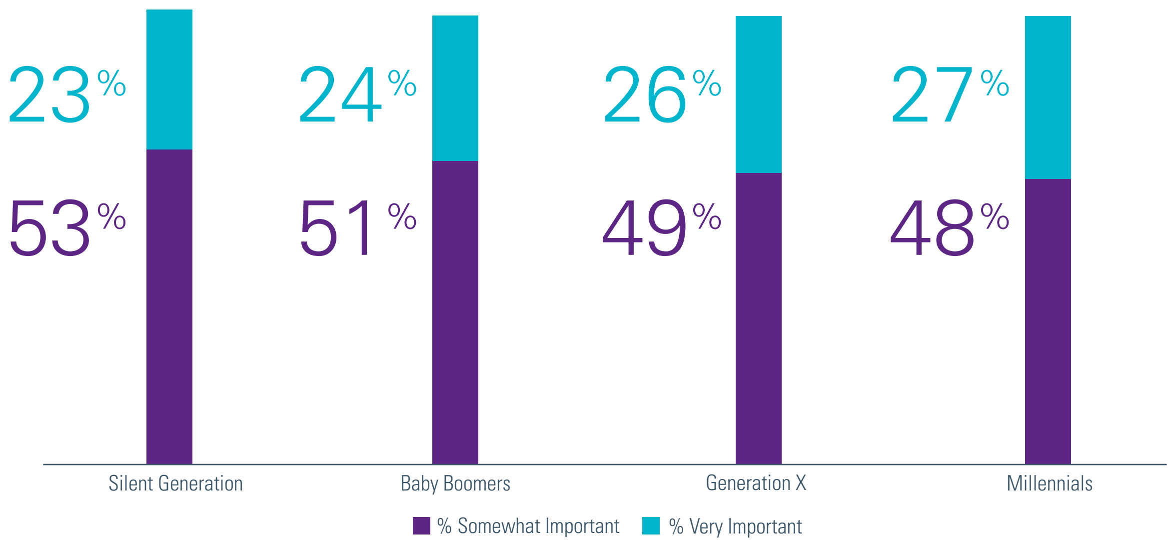
It starts with a question of definition. For many, ESG may be associated with one style: negative screening. Sometimes referred to as SRI (socially responsible investing), negative screening aims to weed out specific sectors such as the so-called sin stocks of alcohol, tobacco and firearms. Essentially, clumsy negative screens cut out sectors, but do not help identify better investment opportunities: a key difference with many other styles of incorporating ESG criteria.

Other investment processes that look at ESG criteria can apply screens as well, but most often specific stocks are eliminated as a risk management protocol. Practical applications go well beyond Volkswagen: These types of screens and the due diligence behind them seek to identify the risks presented by price-gouging practices at EpiPen manufacturer Mylan, the ethical deficiencies around blood testing accuracy at biotech start-up Theranos, or averting environmental losses racked up by British Petroleum in the wake of the Deepwater Horizon oil spill and the subsequent Gulf Coast clean-up.

But for every negative screen, there can be another, potentially positive, opportunity to access return potential in companies that adhere to positive environmental, social and governance policies or within sustainable investing themes that are playing out across the global economy, and that's something negative screening may struggle to capitalize on. A $118 billion green bond market[3] presents opportunity in the funding of sustainable infrastructure across the world. Innovations in solar power and electric vehicles are creating new companies, new products, new supply chains and new opportunities to capture earnings growth globally. Alongside these direct themes are the sweeping demographic changes leading to the development of modern super cities and the development of new return sources for investors. Even companies who have been called out on ESG challenges, like Volkswagen, may turn out to have more positive profiles in screens as they address shortcomings and improve governance.

The key to bridging the gulf between the sentiment of individual investors and the skepticism of professional investors may be using more exact language about ESG and more thorough conversation about the purpose it plays in portfolios.

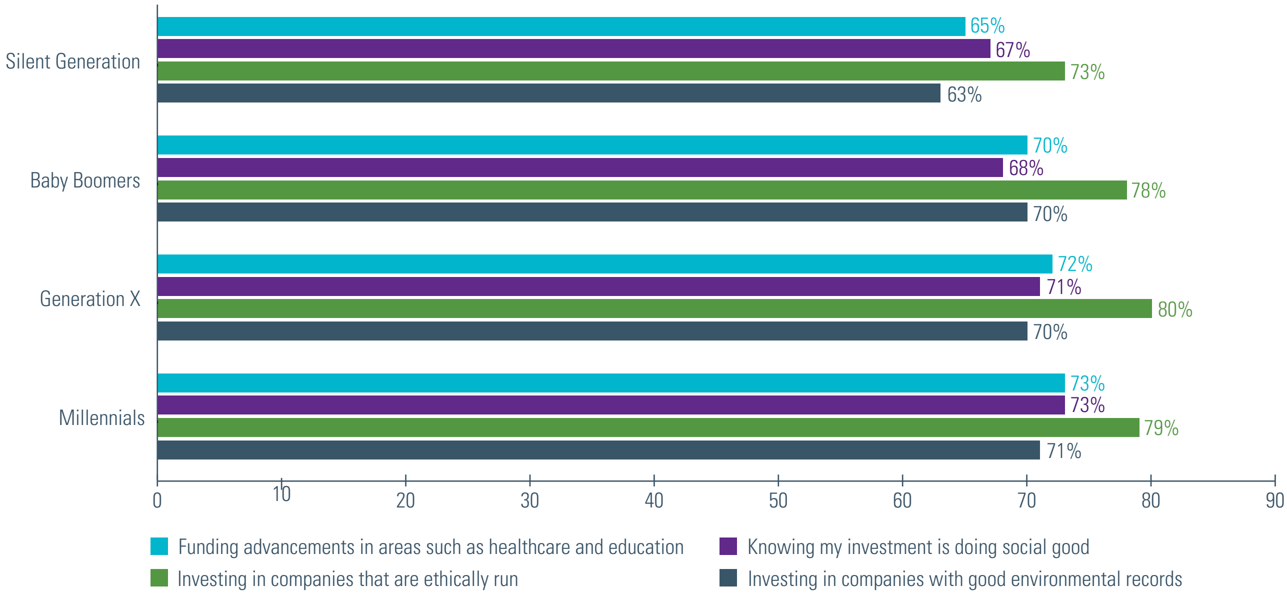
Individuals want investments that match their personal values



3 Bonds and Climate Change: The State of the Market in 2016, July 2016

Values and investment decisions

Individual investors identify the importance of the following factors in their investment decision-making



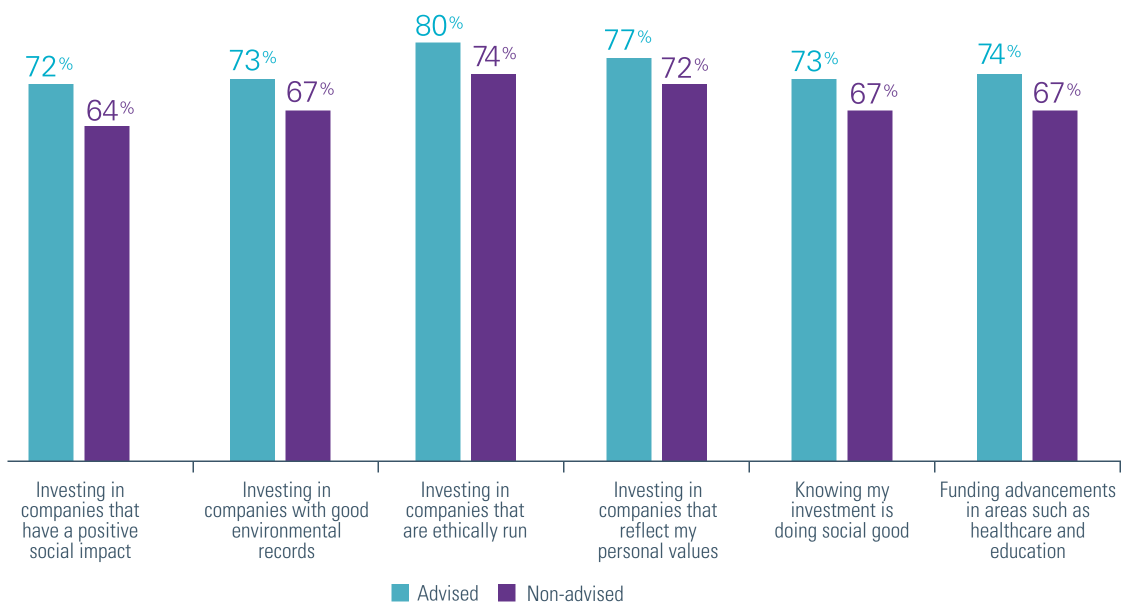
Do the right thing

Investors globally seem to subscribe to the proposition that not only can values-based investing make them feel good about their investments, but it can also generate alpha.[4] Among the 7,100 individuals from 22 countries who were included in our 2016 Global Survey of Individual Investors,[5] we find a consistent belief that it is important to address ESG factors in their investments. We also find that there are specific investor types with even greater propensity for investing in companies and industries that meet these standards.

Three-quarters of investors globally say it is important that they invest in companies that reflect their personal values. This opinion is held consistently across gender, generation, and wealth bands within our survey population. However, within the financial services industry, values-based investing has only recently made inroads in the offerings tailored to higher-net-worth investors, often within family office operations.

Swiss banking giant UBS identified demand for this investment approach, and in 2009 unified social investing alongside philanthropy and strategic charitable services within its wealth management unit. UBS Philanthropy and Values-Based Investing supports ultra-high-net-worth clients and is focused on aligning environmental and social values within client portfolios by deploying a range of strategies, including socially responsible investment screens, thematic investing and impact investing.

Investors who work with advisors are more interested in ESG



4 Alpha is a measure of the difference between a portfolio's actual returns and its expected performance, given its level of systematic market risk. There is no guarantee that any investment will generate alpha.

5 Natixis Global Asset Management, Global Survey of Individual Investors conducted by CoreData Research, February-March 2016. Survey included 7,100 investors from 22 countries.

Clear definition on personal values

Those in our survey pool have clear ideas about where their values lie, with a large majority stressing the importance of investing in companies with sound environmental records (70%) and companies that are seen as doing social good (71%), and making investments that help to fund advancements in healthcare and education (71%). Of all the factors they consider, the largest number of individuals stress the importance of investing in companies that are ethically run (78%).

In terms of who may place the greatest importance on these factors, we see that a slightly larger percentage of women are concerned with ESG factors compared to men. Overall, we see a four- to six-point difference in their opinions across all factors. Given the recent examples of Volkswagen, Mylan, and Theranos that have made headlines since 2015, investing in ethically run companies is where respondents place the greatest emphasis, with 81% of women saying it is important including 33% who say it is very important.

Telling trends from the U.S.

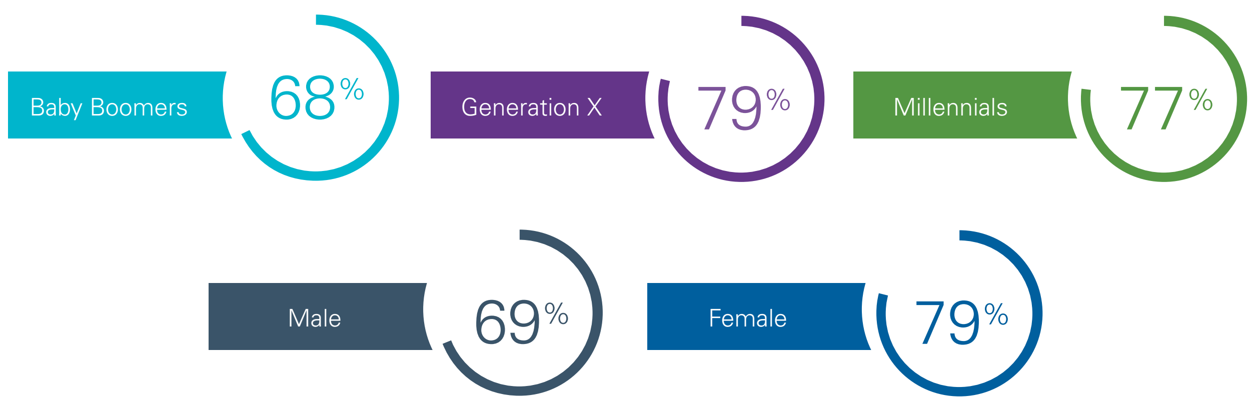
Within the 22 countries included in our survey, we find one group in the U.S. stands out more than any others for the degree to which they stress the importance of ESG factors: investors who work with financial advisors. In terms of investing in companies that make a positive social impact, we see a 17-point spread between investors with advisors (76%) and those who are self-directed (59%). The trend is clear for those who say a company's environmental record is important (74% of advised investors versus 62% of self-directed investors) and those who say it's important to invest in ethically run companies (86% of advised versus 77% of non-advised). What is most surprising within this trend is that the spread is consistent across wealth bands; mass-market clients are just as likely to say these factors are important as emerging high-net-worth and high-net-worth clients.

We also see generational differences in the opinions of U.S. investors, but where there may be an assumption that Millennials (age 18–35) have a more idealistic and egalitarian world view and are the most interested in ESG, there are clear generational differences from issue to issue. While Millennial views (69%) on investing in companies with good environmental records are on par with the overall U.S. survey group (70%), the clearest difference of opinion shows up in the members of the older Generation X cohort (age 36–50).

When asked about investing in companies that are ethically run, 92% of Generation X say it's important, while 81% of Baby Boomers and only 77% of Millennials agree. It's important to note that while many discussions of Millennials say their worldview has been shaped by the Global Financial Crisis, members of Generation X also were coming of age as investors during the dot-com bubble and the subsequent WorldCom and Enron accounting scandals during the early 2000s. After weathering this first downturn and building assets over time, they likely had more money to lose in 2008–2009. It is very likely that this double dose of losses has shaped the investing views of this generation.

While a majority of investors worldwide stress the importance of considering ESG factors in their investments, a separate study of defined contribution plan participants in the U.S. demonstrates that connecting investments to personal values could serve as an effective savings incentive.[5]

DC participants want access to investments that incorporate ESG in their retirement plan offering



5 Natixis Global Asset Management, Survey of U.S. Defined Contribution Plan Participants conducted by CoreData Research, August 2016. Survey included 951 U.S. workers, 651 being plan participants and 300 being non-participants.

The investment professional's view on ESG

Source: Natixis Global Asset Management, Global Survey of Institutional Investors conducted by CoreData Research in October and November 2016. Survey included 500 institutional investors in 31 countries.

Making ESG part of the plan for retirement

Results from our 2016 Survey of U.S. Defined Contribution Plan Participants highlight the potential impact that ESG may have on both attracting more participants into company plans and getting participants to increase contribution rates.

Like the individuals included in our global investor survey, individuals in the U.S. who have access to a defined contribution retirement savings plan believe ESG factors can play an important part in their investments. More than eight in ten of these individuals say they would like to have their investments reflect their personal values.

More than six in ten participants say they are concerned about the environmental, social and ethical records of the companies in which they invest. But almost half (48%) of plan participants say they have not changed the investments selected as their default option on enrollment. Assuming that many of these participants are likely to be invested in target date funds, getting to the records of companies included in their fund may require additional homework. These funds are generally a bundled solution that groups a number of underlying funds in a single portfolio. The details are certainly available, but participants may need to dig deeper than their account statement to determine if their investments support their values and views.

Not only are participants concerned with these factors, but they would also like to have the opportunity to act on their values. Three-quarters say they would like to see more socially responsible options included in their retirement plan. SRI was used as a proxy for ESG since it is a term that has generally been used more frequently in public discussion of these investment objectives. Among this group, there are distinct differences of opinion based on gender and age:

- Women (79%) are more likely to want to see more of these options available in their plans than men (69%).
- Younger participants, including 77% of Millennials and 79% of Generation X, are more likely to ask for these options than Baby Boomers (68%).

Addressing this interest in ESG could help plan sponsors meet goals for increasing plan participation. Given these investment choices, 67% of those with access to a plan who do not participate say they would start contributing, and six in ten participants say they would increase their current contribution rate if they knew their investments were doing social good.

Given that conventional participant education stresses getting an early start on retirement savings, it is important to note that 71% of Millennials say knowing their investments are doing social good would give them an incentive to save more. Offering these types of investments could also complement college loan repayment benefits offered by a growing number of employers to help drive participation early in workers' careers.

The challenge to implementation of these strategies may be overcoming the views of professional investors who may not have followed the evolution of ESG.

Redefining the professional view

While ESG may not be as familiar to financial advisors as traditional investment strategies, the discipline is gaining more attention within the financial services industry. Forty percent of advisors globally and 31% in the U.S. are already using ESG in seeking to mitigate governance and social risks.

Institutions anticipate a greater role for ESG, with six in ten predicting that it will become a standard practice for their organization within the next five years. In terms of portfolio management, 57% say ESG can help mitigate headline risks and 55% say there is alpha to be found in ESG.

Successful implementation is not without challenges. Reporting on both financial and non-financial performance ranks as a top hurdle for institutions, while advisors are challenged by the lack of a sufficient performance track record. Major fund ratings bureaus and research houses are helping to reduce the difficulty of performance reporting by introducing tools to address monitoring and measurement of ESG factors.

Morningstar recently introduced sustainability ratings for mutual funds that measure how well the holdings in a portfolio manage ESG risks and opportunities as compared to their peer group. The MSCI ESG Index Family provides an integrated solution for examining environmental, social and governance factors, flagging outliers in institutional portfolios and providing company performance factors. The index does not exclude industries or sectors; instead, companies within a sector are ranked relative to each other. Barron’s, Thomson Reuters, and Bloomberg have also introduced ESG rankings and tools to support analysis.

A different kind of conversation

Getting past the perceptions of ESG as merely blocking out companies through negative screens will require a mind shift. Looking at the themes driving both public sentiment and investment opportunity, it is clear that the opportunity for ESG is much bigger and it is likely that both individuals and institutions can agree that demographic shifts, burgeoning industries and sustainable growth initiatives can add up to investment opportunity.

PROGRAM OVERVIEW

About the Durable Portfolio Construction® Research Center

Investing can be complicated: Event risk is greater and more frequent. Volatility is persistent despite market gains. And investment products are more complex. These factors and others weigh on the psyche of investors and shape their attitudes and perceptions, which ultimately influence their investment decisions. Through the Durable Portfolio Construction® Research Center, Natixis Global Asset Management conducts research with investors around the globe to gain an understanding of their feelings about risk, their attitudes toward the markets and their perceptions of investing.

Research agenda

Our annual research program offers insights into the perceptions and motivations of individuals, institutions and financial advisors around the globe and looks at financial, economic and public policy factors that shape retirement globally with:

- Global Survey of Individual Investors – reaches out to 7,100 investors in 22 countries.
- Global Survey of Financial Advisors – reaches out to 2,550 advisors in 15 countries.
- Global Survey of Institutional Investors – reaches out to 500 institutional investors in 31 countries.
- Natixis Global Retirement Index – provides insight into the environment for retirees globally based on 18 economic, regulatory and health factors.

The end result is a comprehensive look into the minds of investors – and the challenges they face as they pursue long-term investment goals.

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