Dispelling the Five Common Myths

A GUIDE TO ESG INVESTING

NEW YORK LIFE INVESTMENTS

Overcoming misconceptions about ESG investing

In 2020, over $17 trillion in assets was managed using an ESG-related investment approach in the U.S. alone, compared to $639 billion in 1995.[1]

In recent years, "ESG investing"— meaning investment strategies that incorporate environmental, social, and governance (ESG) factors alongside traditional financial analysis—has grown considerably in attention and assets under management (AUM). According to a 2020 study, more than $17 trillion in assets in the U.S. alone was managed using an ESG-related investment approach, compared to $639 billion in 1995.[1]

Despite this exponential growth, financial professionals and individual investors have remained largely on the sidelines, even as institutional investors have embraced ESG investing. Of the $17 trillion of total AUM in ESG strategies, it's estimated that 74% were managed on behalf of institutional investors, while the remainder was managed on behalf of individual investors.[1]

In a 2019 study performed here at New York Life Investments, we found that only 20% of investors surveyed had a financial professional who recommended using an ESG-based strategy—while 38% of those same respondents stated they have an extremely high interest in discussing these types of strategies with their financial professional in the future.[2]

So, what are the reasons financial professionals and individual investors are holding back? Well, the industry's fondness for jargon certainly hasn't helped matters. A confusing range of acronyms—ESG, SRI, SDG, PRI, and so on may be one barrier. In addition, there are persistent misconceptions about ESG investing. Many of these myths have some basis in reality, which may be why they continue to persist so stubbornly. In this piece, we address some of those key myths and shine a light on the realities of ESG investing.

Five myths of ESG investing

Empirical evidence supports the notion that ESG strategies often have outperformed conventional strategies.

Myth 1: ESG strategies have underperformed conventional strategies

Reality: ESG strategies tended to perform in line or better than conventional strategies

The so-called "performance trade-off" myth is probably the most entrenched misconception surrounding ESG investing. Despite evidence to the contrary, many investors still think they need to sacrifice returns in order to invest following ESG principles.

In 2015, academics analyzed more than 2,000 studies to investigate how companies with strong ESG profiles compared with those with lower ESG profiles. The paper determined that individual companies with strong ESG profiles tended to outperform their non-ESG counterparts (of course, past performance is no guarantee of future results). The authors suggest that strategies focusing on companies with good ESG practices were investing in "better" companies. The article concludes that "the business case for ESG investing is empirically well-founded," and the authors state, "We clearly find evidence for the business case for ESG investing. This finding contrasts with the common perception among investors."[3] The fact that the authors acknowledged that their findings depart from the consensus shows just how entrenched this myth has become over time.

Along with academic research, industry studies have also debunked the idea that ESG strategies underperformed conventional approaches. In April of 2020, Morningstar published an article that showed 44% of ESG equity funds were ranked in their category's "best" quartile, and that only 11% finished in their category's "worst" quartile. That means four times as many ESG equity funds finished at the top of their respective category vs. the bottom. Additionally, 70% of all ESG equity funds ranked in the top half of their respective category.[4] While ESG strategies are varied, both academic research and real returns suggest that investing in ESG investments doesn't mean compromising on performance.

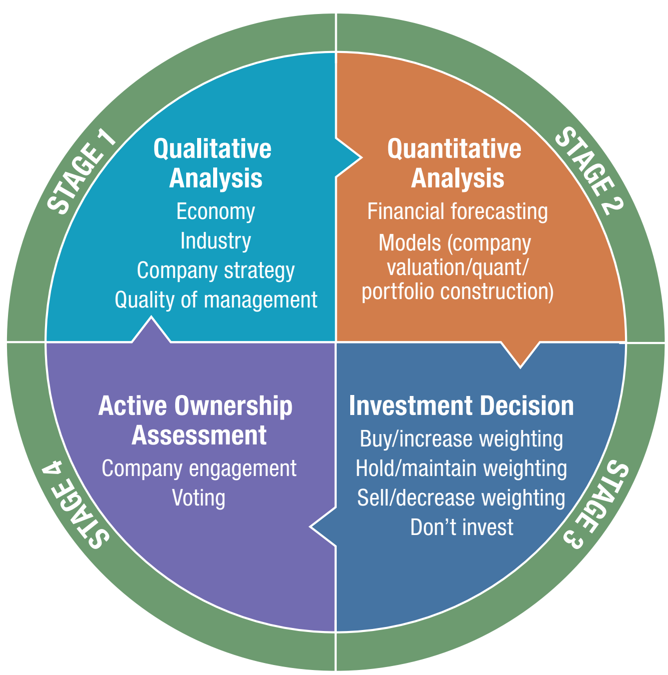
Myth 2: ESG investing only involves screening out "sin" stocks

Reality: Investment approaches that include the use of ESG-related factors are gaining rapidly

The myth that ESG strategies are purely exclusionary has some basis in history. Many of the original, socially responsible investing (SRI) strategies—thought to have had its roots with the Quakers and Methodists in the 1700s—followed an exclusionary approach that allowed religious and other organizations to avoid investments that violated their worldview.[5] In modern investing, exclusionary or "screens-based" approaches tend to avoid stocks or bonds of companies that manufacture or distribute alcohol, tobacco, or firearms, as well as those that operate casinos. For instance, the $345 billion California Public Employees' Retirement System (CalPERS) divested from tobacco stocks in its internally managed portfolio in 2001 and removed an additional $500 million in tobacco stocks managed by its outside investment managers in 2016.[6]

In contrast to negative screens, investment managers are increasingly viewing ESG with a positive approach by integrating ESG-related factors throughout the investment process. To encourage this approach, the United Nations-sponsored Principles for Responsible Investing (PRI) set forth guidelines for investment managers to formally integrate ESG analysis, as shown in **Figure 1**.[7] In its 2020 annual report, PRI signatories—both asset managers and asset owners—represented over $103 trillion in global assets. All signatories are encouraged to incorporate ESG factors in their investment processes. The PRI believes that encouraging investment in companies with strong ESG profiles will benefit the world, and investment managers increasingly view ESG as an alpha source to potentially benefit their clients. While negative screens will continue to exist, incorporating ESG-related investment factors into the process appears to be the future of ESG investing.

Figure 1: PRI Guidelines for Investment Managers to Formally Integrate ESG Analysis[7]

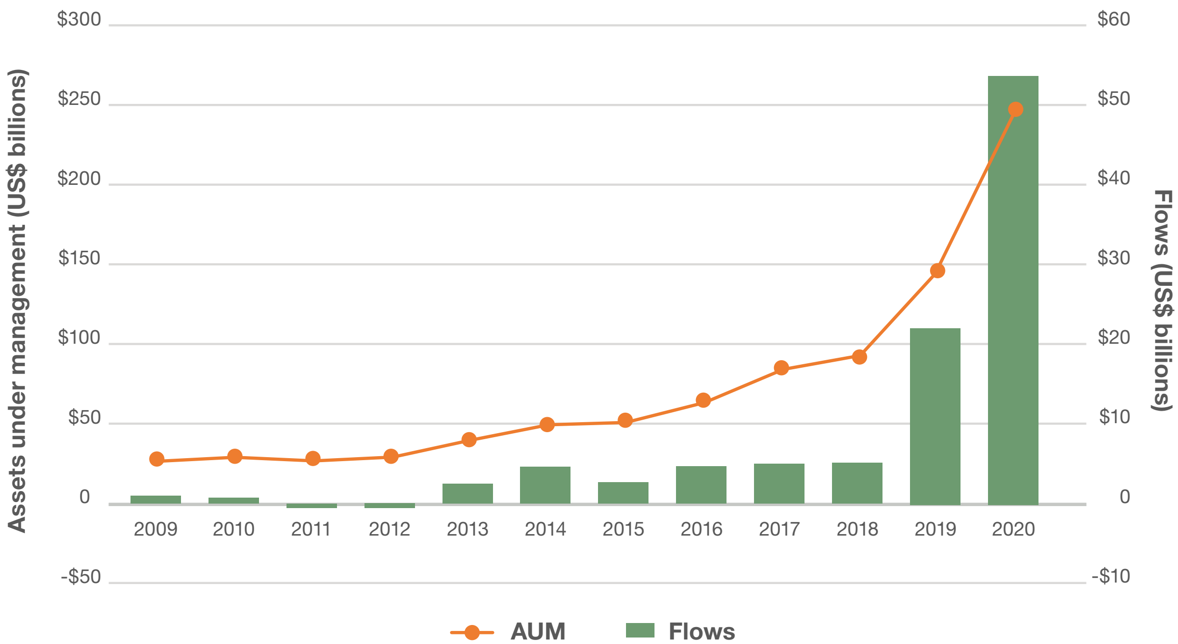


Myth 3: ESG investing is a passing fad

Reality: ESG investing continues to grow in assets and fund offerings

ESG investing has been around for decades and continues to grow. As shown in **Figure 2**, ESG-related strategies have shown consistent inflows and asset growth over the past decade.

Figure 2: ESG-related Strategies Have Shown Strong Growth in AUM and Positive Asset Flows[8]



The number of ESG-related offerings has continued to increase as well. At the end of 2020, Morningstar recognized 392 sustainable, open-end funds and ETFs, an increase of 30% from 2019. This group has experienced a nearly fourfold increase over the past ten years, with significant growth beginning in 2015. Morningstar also noted that sustainable funds attracted a record $51.1 billion in net flows in 2020, more than twice the previous record set in 2019. Sustainable fund flows accounted for nearly one-fourth of overall flows into funds in the U.S. Clearly, this area is growing and will likely continue to increase in the years ahead.[8]

ESG-related strategies have shown consistent flows and asset growth over the past decade.

Myth 4: Only millennials and women are interested in ESG

Reality: There's widespread interest in ESG strategies, with institutional investors leading the charge

It's a common stereotype that younger investors tend to care more about the social impact of their investments than previous generations. However, our research has backed up this claim, suggesting that millennials do indeed factor in ESG concerns more than other investors. For instance, our study found that millennial investors are more than twice as likely (62%) to invest in companies or funds that target specific social or environmental outcomes compared with other investors (31%).[9] Additionally, another study found that 29% of investors in their 20s and 30s prefer to work with a financial professional that offers ESG investing.[10]

However, the facts don't bear out the idea that millennials are the primary investors in ESG strategies. In reality, institutional investors have adopted ESG investments more than any other group. As noted earlier, institutional investors account for nearly three-quarters of the assets managed following an ESG approach. They've been leading the charge of ESG investing, while individuals have been slower to adopt ESG strategies.[1]

That does not mean there's no market for ESG strategies for individual investors. Quite the opposite. According to a Morningstar study published in April 2019, 72% of the United States population expressed at least a moderate interest in ESG investing.[11] And, when it comes to men and women investors, our research found no statistically significant difference in preferences for ESG strategies by gender, as both men and women were nearly equally open to ESG strategies.[9] According to these results, there could be a large, relatively untapped market of individual investors who want to learn more about ESG strategies.

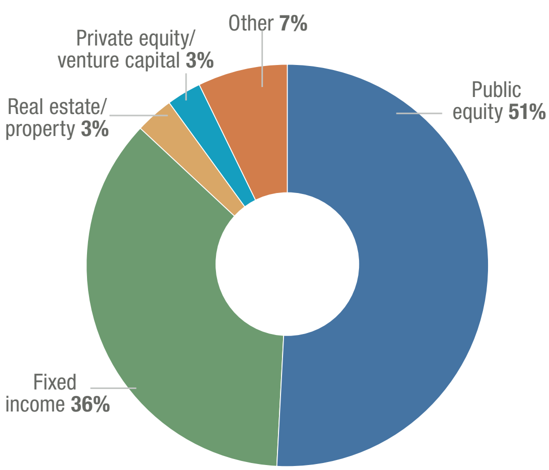
Contrary to popular belief, institutional investors have adopted ESG investments more than any other group.

Myth 5: ESG investing is only applied to equity funds

Reality: ESG strategies are available across asset classes

Other asset classes are increasingly incorporating ESG analysis into the investment process. As shown in **Figure 3**, more than half of global ESG assets were in publicly listed equities, as of 2018—though fixed-income assets represented more than a third of these assets. Alternative assets, including real estate, private equity, venture capital, and hedge funds, among others, represent more than 10% of ESG-related managed assets.[12]

Figure 3: Integration of Global Sustainable Investments Across Asset Classes (as of 2018)[12]



Source: Global Sustainable Investment Alliance, "2018 Investment Review." NOTE: "Other" includes hedge funds, cash, commodities, infrastructure, and unclassified assets. It does not include asset breakdown for Australia and New Zealand.

According to the PRI, the percentage of ESG-related equity investments remained unchanged from 2017 to 2018, while fixed-income and alternative assets showed significant growth over this period.[13] This higher growth rate indicates that these other asset classes are likely to continue increasing their share of assets invested in an ESG-related fashion. Additionally, according to Morningstar, of the 392 sustainable funds available as of December 2020, 269 were equity funds, 74 were fixed-income funds, and 47 were allocation funds. Investors have the most choices in U.S. equity with 134 funds. Another 99 funds were either world-stock or international-equity funds. Among fixed-income funds, 26 were intermediate-term funds. Overall, investors can find sustainable funds in 65 categories.[8]

While equity flows continue to dominate, flows into sustainable, fixed-income funds totaled a record $6.4 billion in 2020, representing about 13% of overall flows. The number of sustainable, fixed-income funds has increased substantially since 2015—from 20 to 74 funds.[8] While fixed-income assets managed following ESG guidelines still lag their equity counterparts due to the lack of data and standardization, the recent increase in fixed-income ESG funds suggests this area has room to grow.

Know the facts

Myths and misconceptions about ESG investing are likely to persist. Our goal is to arm you with facts to help navigate the expanding ecosystem of ESG investing. We believe there's potentially strong demand for ESG strategies, but education will clearly play a key role in moving the conversation forward.

For more information on ESG investing, visit us at: newyorklifeinvestments.com

1. Source: The Forum for Sustainable and Responsible Investment (US SIF), “Trends Report 2020.”

2. Source: New York Life Investments and RTi Research, September 2019. Results based on survey questions asked of 594 investors, both men and women, with investable assets over $250k, ranging in age from 25-39; 40-54; and 55+.

3. Source: Gunnar Friede, Timo Busch, and Alexander Bassen (2015), “ESG and financial performance: aggregated evidence from more than 2000 empirical studies,” Journal of Sustainable Finance & Investment, 5:4, 210-233.

4. Source: Morningstar article, “Sustainable Funds Weather the First Quarter Better Than Conventional Funds,” 4/3/20.

5. Source: Frank A.J. Wagemans, C.S.A. (Kris) van Koppen, and Arthur P.J. Mol (2013), “The effectiveness of socially responsible investment: a review,” Journal of Integrative Environmental Sciences, 10:3-4, 235-252.

6. Source: Randy Diamond, “CalPERS Decision to Divest from Tobacco Is Costly,” Chief Investment Officer, 12/12/18.

7. Source: Principles for Responsible Investing, “A Practical Guide to ESG Integration for Equity Investing,” 2016.

8. Source: Morningstar, “Sustainable Funds U.S. 2020 Landscape Report,” February 2021.

9. Source: New York Life Investments and RTi Research, September 2019. Results based on survey questions asked of 594 investors, both men and women, with investable assets over $250k, ranging in age from 25-39; 40-54; and 55+.

10. Source: Ernst & Young, “Sustainable investing: the millennial investor,” 2017.

11. Source: Morningstar, “The True Faces of Sustainable Investing: Busting Industry Myths Around ESG,” April 2019.

12. Source: Global Sustainable Investment Alliance, “2018 Investment Review.”

13. Source: United Nations Sponsored Principles for Responsible Investing, “Annual Report 2018.”

ABOUT RISK

Investing involves risk, including possible loss of principal. Asset allocation and diversification may not protect against market risk, loss of principal, or volatility of returns. There is no guarantee that these investment strategies will work under all market conditions or are suitable for all investors, and each investor should evaluate their ability to invest long term, especially during periods of downturn in the market. No representation is being made that any account, product, or strategy will or is likely to achieve profits. This material has been prepared for informational purposes only, and is not intended to provide, and should not be relied on for, accounting, legal, or tax advice. You should consult your tax or legal advisor regarding such matters. This material is not intended to be relied upon as a forecast, research, or investment advice, and is not a recommendation, offer, or solicitation to buy or sell any securities or to adopt any investment strategy.

Impact investing and/or environmental, social, and governance (ESG) managers may take into consideration factors beyond traditional financial information to select securities, which could result in relative investment performance deviating from other strategies or broad market benchmarks, depending on whether such sectors or investments are in or out of favor in the market. Further, ESG strategies may rely on certain values-based criteria to eliminate exposures found in similar strategies or broad market benchmarks, which could also result in relative investment performance deviation. Opinions expressed are current opinions as of the date appearing in this material only and are subject to change.

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DEFINITIONS

Alpha is a term used in investing to describe a strategy’s ability to beat the market or provide excess return. **Alternative investments** are speculative, not suitable for all clients, and intended for experienced and sophisticated investors who are willing to bear the high economic risks of the investment. **Bonds** are subject to credit risk, in which the bond issuer may fail to pay interest and principal in a timely manner. **Commodities** markets are subject to greater volatility than investments in traditional securities, such as stocks and bonds. **Fixed-income securities** are subject to credit risk—the possibility that the issuer of a security will be unable to make interest payments and/or repay the principal on its debt—and interest-rate risk—changes in the value of a fixed-income security resulting from changes in interest rates.

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