Graystone Consulting

The Convergence of Investing with Impact and Institutional Consulting

PART 1: THE GROWTH OF INVESTING WITH IMPACT

Investing with Impact is drawing significant attention as it becomes increasingly evident that integrating an organization's mission into its investment strategy can manage risk, unlock new opportunities and provide competitive returns—all while making a positive impact on the world. Yet there has been little focus on helping institutional investors evaluate the impact-readiness of one crucial part of the investment ecosystem: their institutional consultants.

The institutional consulting industry, which guides the decision-making of nearly 84% of institutional dollars, has the potential to play a crucial role in the growth of the sustainable and impact investing market sector. While uptake by consultants has been generally slow—because it requires new capabilities and a distinctly unique mindset—the competitive landscape for the consulting industry is changing. The growing demand by pension funds, endowments, foundations, nonprofits as well as religious institutions and other institutional investors, together with the transfer of wealth toward millennials, increased data and corporate reporting, and an evolving global regulatory backdrop are all driving the evolution of the investment consulting industry toward Investing with Impact.

This publication is the first in a two-part series. Part 1 will explore the growth of Investing with Impact and ways in which institutional investors can accelerate the flow of capital to generate positive environmental and social impact as well as meet their long-term financial goals. Part 2 will outline the new capabilities that consultants need and provide critical questions for investors to discuss with their consultant team, ensuring they are properly equipped to navigate this rapidly evolving landscape.

A Taxonomy of Investing with Impact

With so many overlapping terms used to describe mission-aligned, sustainable and impact investing, it's helpful to clarify definitions. In this primer, we will refer to the following approaches:

INVESTING WITH IMPACT
Morgan Stanley's proprietary investment platform and framework, which clarifies a continuum of approaches to achieve market-rate financial returns alongside positive social and/or environmental impact.

SUSTAINABLE INVESTING
The general practice of making investments in companies or funds that aim to achieve market-rate financial returns alongside positive social and/or environmental impact.

RESTRICTION SCREENING
An investment approach where investors manage their exposures to companies, sectors or geographies by intentionally avoiding investments in business activities or practices they find objectionable Across certain industries, such as tobacco and weapons, restriction screening has historically been referred to as "socially responsible investing."

ESG INTEGRATION
Environmental, social and governance (ESG) integration proactively considers ESG criteria alongside financial analysis to identify opportunities and risks during the investment process. ESG integration may consider corporate practices such as natural resource utilization, human capital policies and board governance, as well as a company's products and solutions. ESG data and ratings can help investors identify ESG leaders and laggards, enhance risk-mitigation strategies or inform business valuation.

THEMATIC EXPOSURE
Focuses on themes and sectors dedicated to solving sustainability-related domestic and global challenges, such as climate action, gender equity or inclusive workplaces.

IMPACT INVESTING
Allocates to private-market investments to deliver specific social and environmental impacts. These investments tend to be alternative investments, such as private equity and debt as well as venture capital for qualified investors, and are differentiated by their focus on specific impact.

SHAREHOLDER ENGAGEMENT
Investment stewardship activities, including engaging with company management and exercising proxy voting rights, that provide opportunities to guide companies toward better governance practices.

Institutions Driving Investing with Impact

Institutions such as endowments, foundations, nonprofits and religious institutions are increasingly deploying capital across their investments in ways that are aligned with their mission and/or charitable goals. Other institutions, such as pension funds, are increasingly seeking ways to mitigate long-term risk in their overall allocation decisions. Today, in addition to the approximately 1.56 million registered tax-exempt public charities in the U.S., there are over 105,000 private foundations and over 368,000 nonprofit organizations, such as civic leagues and fraternal organizations.[2, 3] In 2019, these tax-exempt organizations had a combined $5.79 trillion in total assets.[4]

These organizations, foundations and endowments typically aim to sustain their rate of asset usage over a long-term horizon, with limited liquidity needs—on average, about 5% of their value.[5] This stable, long-term focus gives them flexibility while requiring them to manage multiple long-term risks, including environmental and social risks like climate change. Together, these factors reward a forward-thinking mindset that has seen institutional investors increasingly seek to incorporate ESG criteria in their investment portfolios. A 2018 survey conducted by the Morgan Stanley Institute for Sustainable Investing of 118 public and private institutional asset owners such as pensions and endowments found that 84% are currently pursuing or are considering pursuing ESG integration in their investment process.[6]

Asset owners wishing to align investments with their missions were further reassured by 2018 guidance from the Department of Labor that the integration of ESG factors in investment selection and proxy voting policies is consistent with fiduciary duty, as long as these are financially material considerations.[7]

A Trend in Lockstep With Institutions

Investing with Impact enables investors to create real value both within their investment portfolios and for society more broadly. There are six core reasons why the growth of Investing with Impact has tremendous potential:

1. A CONCEPT ROOTED IN VALUES AND ACCELERATED BY CATALYTIC FAMILIES AND FOUNDATIONS

Built on a strong legacy, Investing with Impact is historically rooted in actions taken by faith-based institutions, such as the Quaker Friends Fiduciary Corporation, which in 1898 adopted the first socially responsible investment policy by restricting weapons, alcohol and tobacco.[8] Beginning in the 1970', individual and institutional investors aligned around important issues, such as apartheid in South Africa, and pushed for the creation of dedicated industry networks, the Interfaith Center on Corporate Responsibility (ICCR) and frameworks such as the Global Reporting Initiative and the Carbon Disclosure Project.

Pioneering high net worth families, individuals and foundations were increasingly joined by nonprofits, endowments, pension funds and other institutional investors who demanded transparency on social and environmental corporate practices, and began leveraging this data into their investment decisions. Some also sought to achieve the dual goal of making money while generating solutions to some of the world's greatest challenges—alleviating poverty, striving for social and racial justice, protecting the environment and more. In 2007, the term "impact investing" was coined to define a category of investments intentionally seeking to generate social and environmental value, and in the last decade, this approach to investing has moved further into the mainstream, bringing increased rigor in measurement, a focus on outcomes and dramatically increased investment offerings.

A Tradition of Investing with Impact

Once considered a niche investment trend, investing to generate competitive risk-adjusted returns and positive environmental and social impact has evolved into one of the top areas of investor focus. Morgan Stanley started Global Sustainable Finance in 2009 to integrate sustainability into each of our core businesses, including Wealth Management and Institutional Consulting. With over a decade of experience, today we are considered an industry leader in this space.

To further this firmwide objective, in 2012 we launched Investing with Impact, the first wealth management platform led by a major financial institution dedicated to giving investors a suite of investment options tailored to their values and impact goals. Investing with Impact includes a range of investments across public and private markets, in addition to customized portfolios, donor-advised fund impact pools and access to capital market opportunities, including green bonds.

2. COMPETITIVE RISK-ADJUSTED PERFORMANCE

Across the approaches outlined in A Taxonomy of Investing with Impact on the previous page, evidence from academic, financial and other mainstream institutions is proving that factoring ESG risks and opportunities into investment decisions may lead to long-term risk-adjusted financial results similar to, and in some cases better than, traditional investing strategies and benchmarks.

Making informed decisions based on corporate sustainability practices is becoming easier as corporations increase transparency: In 2017, 85% of S&P companies published a sustainability report, up from just 20% only eight years prior.[9] Academics have used this data to compare the financial performance of sustainability-focused corporations and strategies to their traditional peers, repeatedly finding that the better performance of ESG leaders is reflected in investment gains in both public and private markets.

One example, a 2016 study by two Harvard University professors, found that firms with higher ratings on sustainability issues most relevant to their industries significantly outperformed those with poor ratings.[10] Their report noted that between 1993 and 2014, a $10,000 investment in a portfolio of stocks performing in the top quintile on relevant ESG factors (such as carbon footprint, board diversity and employee policies) would have returned more than double that of a portfolio of stocks performing in the bottom ESG quintile.[11] Additional factors, such as type of industry, company age/size and superior management, may also have contributed to the additional performance. This applies to private markets as well, with a study of 51 private investment funds concluding that impact investment funds outperformed funds in a comparative universe of traditional private market funds.[12]

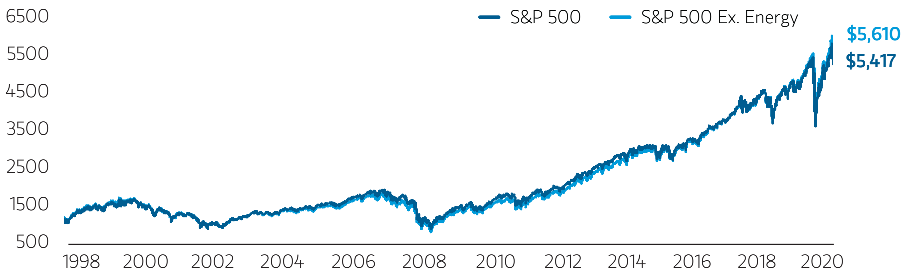
More recent research continues to confirm that Investing with Impact strategies can potentially provide better risk-adjusted returns. A 2019 study of Morningstar ESG indexes found that 41 of the 56 indexes (73%) outperformed their non-ESG equivalents since inception.[13] The study found that ESG considerations may also mitigate risk, with ESG-focused companies possessing lower volatility and healthier balance sheets than their non-ESG equivalents.[14] This is consistent with a 2020 publication from the Morgan Stanley Institute for Sustainable Investing, which showed that sustainable investing is proving a rewarding opportunity for investors during times of both market expansion and severe volatility. During the prolonged 2019 boom, sustainable equity and taxable bond funds outperformed their traditional peers. And they continued to do so during the first half of 2020, weathering the unprecedented global shock triggered by the COVID-19 pandemic better than traditional funds. These findings are the result of analysis on more than 11,000 mutual and exchange-traded U.S.-domiciled funds. The findings provide further evidence that funds incorporating environmental, social and governance (ESG) criteria can potentially provide financial returns in line with, if not better than, traditional funds, and with less downside risk.[15] Companies that outperform on ESG metrics tend to generate returns that are uncorrelated with market factors such as

Evidence of competitive performance is persistent even when specific impact themes are considered, such as mitigating climate change. Environmentally focused investments — excluding traditional fossil fuels and investing in companies with products and services providing climate solutions — are meeting or outpacing comparable traditional benchmarks.

DIVESTING FROM FOSSIL FUELS

Cumulative Return of $1,000 Invested in Securities Comprising The S&P 500 Index Versus S&P 500 Ex. Energy

As of October 2020



					ANNUALIZED RETURNS				
	1-Mo	3-Mo	YTD	1-Yr	3-Yr	5-Yr	7-Yr	10-Yr	20-Yr
S&P 500	-16.21	-19.60	-19.60	-6.93	5.09	6.71	9.60	10.51	1.78
S&P 500 Ex. Energy	-9.31	-18.21	-18.21	-4.43	6.50	7.58	10.09	10.13	3.25

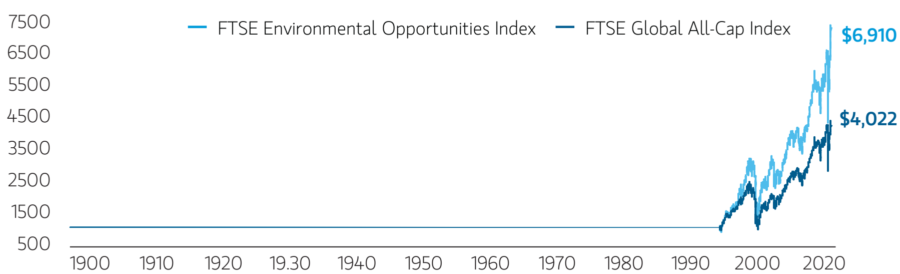
Source: Morgan Stanley Wealth Management, Bloomberg.

Past performance is no guarantee of future results. Estimates of future performance are based on assumptions that may not be realized. This material is not a solicitation of any offer to buy or sell any security or other financial instrument, or to participate in any trading strategy. Please refer to important information, disclosures and qualifications at the end of this material.

INVESTING IN ENVIRONMENTAL LEADERS

Cumulative Return of $1,000 Invested in Securities Comprising the FTSE Global All-Cap Index Versus FTSE Environmental Opportunities Index

As of October 2020



					ANNUALIZED RETURNS				
	1-Mo	3-Mo	YTD	1-Yr	3-Yr	5-Yr	7-Yr	10-Yr	20-Yr
FTSE Environmental Opportunities Index	-16.84	-20.98	-20.98	-8.28	3.00	4.58	6.94	7.00	4.80
FTSE Global All-Cap Index	-9.55	-22.19	-22.19	-11.92	1.32	3.01	5.38	6.00	–

Source: Morgan Stanley Wealth Management, Bloomberg.

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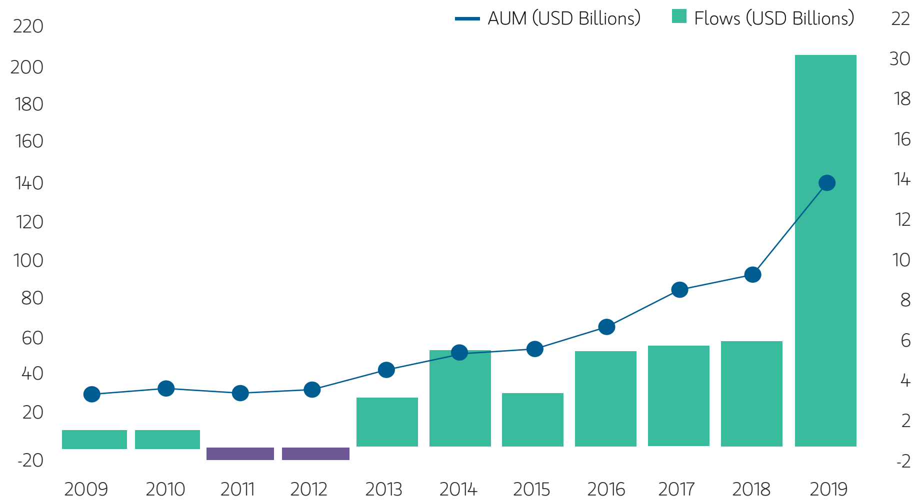
interest rates, so they have the potential to deliver results with lower volatility and less market risk than their public-market peer equivalents.

3. MILLENNIALS ARE ALL-IN

Millennials, who now make up one-third of the U.S. workforce,[16] believe they can make a difference in the world through their investments. Among millennial investors, 95% are interested in sustainable investing. 67% of millennials take part in at least one sustainable investing activity and 90% seek greater opportunity to tailor their investment impact.[17] Millennials are nearly twice as likely as other investors to invest in companies or funds that target specific social or environmental outcomes, and are twice as likely to exit an investment due to objectionable corporate activity.[18]

Millennials and younger generations will not only become the members, donors, plan participants and decision-makers of institutions, but will also inherit an estimated $30 trillion in generational wealth—the largest wealth transfer in history.[19] If they continue to pursue investments that make a positive environmental and social impact, in addition to pursuing their financial goals, this demand will significantly boost the trajectory for impact investments and the underlying research, measurement and advice required to support this sector.

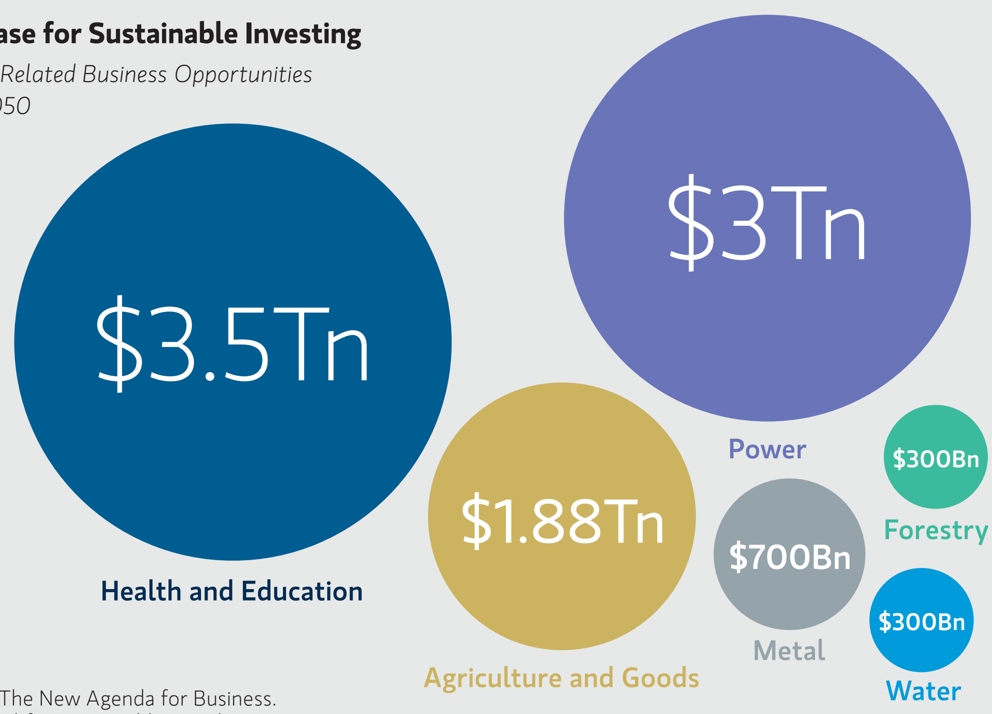
Sustainable Funds in the U.S.: Estimated Annual Flows



Source: Morningstar Direct. Data as of 12/31/2019.

The Business Case for Sustainable Investing

New Sustainability-Related Business Opportunities in Key Sectors in 2050



Source: Vision 2050, The New Agenda for Business. World Business Council for Sustainable Development, 2010.

4. GLOBAL NEEDS WILL DRIVE DEMAND

Given population growth globally, megatrends in sectors such as energy, health, agriculture and education are pointing to an ever-growing market for Investing with Impact strategies, with an estimated investment opportunity of $10 trillion, or 4.5% of GDP by 2050 (see The Business Case for Sustainable Investing on the previous page).[20]

The size of the global sustainable investment market in Europe, the U.S., Canada, Japan, Australia and New Zealand stood at $30.7 trillion at the start of 2018, a 34% increase from two years prior.[21] The two largest markets, Europe and the U.S., have both shown substantial growth. In Europe, the total assets committed to sustainable strategies grew by 11% (to $14.1 trillion) as compared to 2016, and made up 49% of total professionally managed assets. In the U.S., 1 in 4 dollars under professional management is now invested in impact investing strategies, with a growth rate of 38%.[22]

5. GROWING PRODUCT AVAILABILITY ACROSS ASSET CLASSES

Investor demand for products is being met by a growth in offerings across asset classes. In 2018, 75% of asset managers surveyed had adopted some form of sustainable investing strategy, and 89% said that their firms would devote additional resources to it in the next one to two years.[23] Product offerings are growing across the investing approaches outlined on page 2, with 2019 estimated net flows into sustainable funds available to U.S. investors up nearly four times the previous annual record set in 2018, at $20.6 billion for the year (see Sustainable Funds in the U.S.: Estimated Annual Flows chart on the previous page).[24]

6. FIDUCIARY CONSIDERATIONS SUPPORT SUSTAINABILITY

The incorporation of Investing with Impact as part of an organization's fiduciary duty became more common among institutional investors after the Department of Labor's (DOL) Interpretive Bulletin 2015-01[25] clarified that retirement plans subject to the Employee Retirement Income Security Act (ERISA) are fully able to take into consideration Investing with Impact approaches — especially the integration of ESG risks and opportunities — within the context of their fiduciary duty. "Based on the latest guidance, the norm is that a prudently selected, well-managed and properly diversified ESG-themed investment could be part of an investment program."[26]

Further, an update to the DOL's guidance was issued in 2018 that reinforced the legal principles outlined in previous guidance, which had given comfort to fiduciaries who are employing environmental, social and governance investing (other commonly used terms might include "sustainable investing" or "impacting investing") as a way to enhance the research and analytical capabilities of their investment portfolios. The 2018 DOL Field Assistance Bulletin reminds plan fiduciaries that the integration of financially material ESG factors into investment selection and proxy voting policies is consistent with fiduciary duty — i.e., selecting investment managers that incorporate environmental, social and governance factors must be done in consideration of material business risk and return opportunities. However, the new guidance adds that there are guardrails that preclude using ERISA funds to give up return or take on added risk by pursuing collateral social policy goals.[27]

Regardless of whether investors are looking at Investing with Impact from a values-orientation, mission-alignment or, increasingly, from a market-opportunities and risk-mitigation lens, this approach to managing capital across a variety of institutions is only growing in interest and action. Part 2 of this series will examine the role of the institutional consultant in navigating this process.

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Private funds (which include hedge funds and private equity funds) often engage in speculative investment techniques and are only suitable for long-term, qualified investors. Investors could lose all or a substantial amount of their investment. They are generally illiquid, not tax-efficient and have higher fees than many traditional investments.

Investing in the market entails the risk of market volatility. The value of all types of investments may increase or decrease over varying time periods.

The returns on a portfolio consisting primarily of sustainable investments may be lower or higher than a portfolio that is more diversified or where decisions are based solely on investment considerations. Because sustainability criteria exclude some investments, investors may not be able to take advantage of the same opportunities or market trends as investors who do not use such criteria.

Indexes are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only and do not represent the performance of any specific investment. Index returns include the reinvestment of all dividends, but do not reflect the payment of transaction costs, advisory fees or expenses that are associated with an investment. The indexes selected by Morgan Stanley Smith Barney LLC ("Morgan Stanley") to measure performance are representative of broad asset classes. Morgan Stanley retains the right to change representative indexes at any time.

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