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INVESTMENT MANAGEMENT

ESG Investing: Living in a Material World

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Investing sustainably has rapidly gained mindshare with investors, particularly over the past several years. Yet it seems the deeper the dive into what investing sustainably means, the more questions arise. For example, when choosing stocks as part of a portfolio, how does a manager choose one company over another when ESG data sources may not paint a complete picture? Or, if striving for good returns relative to a broad benchmark, how does a manager evaluate and become comfortable owning companies that in a different context might not be considered ESG friendly, companies such as a bank or a utility company? Or, is it necessary to sacrifice performance in favor of sustainable and ethical behavior of companies?

In our mind, the key to answering these key questions is materiality.

ESG: Why materiality matters

ESG investing is specifically focused on evaluating the investment viability of companies through an ESG lens:

- Is a company focused on ways to minimally impact the environment as they make decisions?
- Does it treat its employees and suppliers fairly?
- Does it have the appropriate governance structure in place to deliver results in an ethically sustainable way while managing risk?
- How is a company progressing in its quest to improve its ESG behavior?

"For ESG integration to improve financial results, companies have to focus on the specific ESG issues that will have a **material** impact on their business."

But for ESG investing to improve financial results, companies have to focus on the specific ESG issues that can have a **material** impact on their business. For example, a financial services company renovating a corporate headquarters to be LEED-certified is great for the environment, but that in itself will likely not materially help its bottom line. However, a food distributor reworking supply chain logistics to minimize truck routes will improve the carbon footprint of the planet **and** reduce fuel costs, a material outcome.

Similarly, asset managers must pay attention to material ESG factors when evaluating companies to build a portfolio. Applied Equity Advisors understands that materiality matters, and with increasing evidence that ESG influences performance results, our investment process for all of our actively managed equity products systematically integrates ESG analysis into our stock selection process. Additionally, we have a strategy that launched in 2018, Global Concentrated ESG Equity, which leverages our integrated and systematic ESG analysis and additionally screens out companies in certain industries.

Why ESG integration matters: Research results

While there is plenty of research that indicates that companies focusing on ESG factors do better financially,[1] one study in particular[2] provided evidence that focusing on material ESG factors can lead to superior investment results.

"CORPORATE SUSTAINABILITY: FIRST EVIDENCE ON MATERIALITY"

Aaron Yoon (Kellogg Business School), Mozaffar Khan (University of Minnesota) and George Serafeim (Harvard Business School), the authors of "Corporate Sustainability: First Evidence on Materiality 2015," set out to quantify a correlation between a company's ESG initiatives and financial results in the form of their stock price returns. They felt that providing evidence of positive results when investing in companies with strong ESG performance would allow investors to make better decisions about the value of firms' ESG programs.

The research concluded that not all ESG investments are created equal when it comes to generating returns. The best approach was to buy stock in companies that prioritize ESG issues that are **material** to core business practices for a company's particular sector.

The researchers ranked companies based on a materiality score. They created a portfolio of firms that scored highly on material sustainability issues and compared its stock returns to those of a portfolio of firms that scored poorly on those issues. The difference in stock returns was clear over a 22-year horizon (1992-2013). **On an annualized basis, the portfolio of firms that scored high on materiality delivered returns that were higher than those of the other portfolio.**

"Our paper shows that investing in ESG was not value-disrupting," Yoon says, "as long as the ESG investments the companies make improve materiality."

The Applied Equity Advisors investment process: Emphasizing the material

Many asset managers claim to have addressed ESG issues in their investment process. But what does this really mean? Some might merely exclude "sin" stocks. Others might rely on unadjusted third-party ESG rankings. Others still might talk with company management.

The Applied Equity Advisors team uses elements of screening, company engagement **and** third-party data, but it does so holistically. Our key differentiator is that we systematically integrate ESG analysis into our investment process by thoroughly evaluating those ESG issues that are **material** to the companies under our investment microscope. Being a core equity manager, that link was essential. Our primary mandate is to deliver performance relative to our benchmark, regardless of the market style (valuation, growth, quality) that is in favor. Integrating ESG analysis into our stock selection means utilizing a framework that can be applied to any type of stock, not simply those that are considered "green."

The Applied Equity Advisors investment process is built on the basis of two engines *(Display 1)*. The first engine is the team's proprietary Style Positioning Engine, designed to determine positioning with regard to broad market factors, such as growth, valuation or quality.

Our second engine is our Stock Selection Engine. In selecting stocks, Applied Equity Advisors seeks to first choose those companies that can achieve

DISPLAY 1
Extracting Excess Returns

STYLE POSITIONING	STOCK SELECTION
Valuation	Correlation to factors
Growth	Fundamental Analysis
Quality	ESG Materiality

[1] Axioma, 2018. Boston Consulting Group, 2018. **Past performance is no guarantee of future results.** This is shown for illustrative purposes only and is not and is not meant to depict the performance of a specific investment. The results shown do not take into account any expenses.

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DISPLAY 2

Sampling of Material ESG Issues from SASB Materiality Map®

Material Issues Guiding Applied Equity Advisors Stock Selection

SECTOR	CONSUMER GOODS	FINANCIALS	HEALTH CARE	FOOD & BEVERAGE	TECHNOLOGY & COMMUNICATIONS
INDUSTRY	Apparel, Accessories & Footwear	Commercial Banks	Managed Care	Processed Foods	Semiconductors
MATERIAL ISSUES	Product Quality & Safety Supply Chain Management Materials Sourcing & Efficiency	Data Security Access & Affordability Product Design & Lifecycle Management Business Ethics Systemic Risk Management	Data Security Access & Affordability Product Quality & Safety Customer Welfare Physical Impacts of Climate Change	Energy Management Water & Wastewater Management Product Quality & Safety Customer Welfare Selling Practices & Product Labeling Product Design & Lifecycle Management Supply Chain Management Materials Sourcing & Efficiency	GHG Emissions Energy Management Water & Wastewater Management Waste & Hazardous Materials Management Employee Health & Safety Employee Engagement, Diversity & Inclusion Product Design & Lifecycle Management Materials Sourcing & Efficiency Competitive Behavior

the desired factor positioning from a style and regional perspective prior to conducting its in-depth stock analysis.

The ESG analysis integrated in the Stock Selection Engine starts with a sustainability screen across five dimensions categorized by the Sustainability Accounting Standards Board (SASB):

1. **ENVIRONMENT**
2. **SOCIAL CAPITAL**
3. **HUMAN CAPITAL**
4. **BUSINESS MODEL & INNOVATION**
5. **LEADERSHIP & GOVERNANCE**

It is important note that we objectively choose not to rely solely upon third-party ESG rankings, as we find that ESG data is imperfect, might have a lag, and represents only a single point of view. More importantly, we find that third-party rankings do not always focus enough on ESG factors that are material to a business, and thus do not tell the complete story.

To help determine the ESG issues most relevant for a given company, our internal analysts license the intellectual property behind the SASB Materiality Map®[3], a critical resource that pinpoints sustainability issues that have been identified as likely to affect the financial condition or operating performance of companies within an industry.

"The guidance and information provided by the SASB Materiality Map® allows the Applied Equity Advisors team to be efficient with its resources and spend time on what matters, or is truly material to the desired outcome."

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SASB identifies 26 sustainability-related business issues, known as general issue categories that apply across multiple industries, and Disclosure Topics and associated Accounting Metrics that vary across 11 sectors and 77 industries *(Display 2)*. For example our analysts will understand from the map that Data Security is a material ESG issue in the Commercial Banking and Managed Care industries and less so or not at all likely to be material in Apparel, Accessories & Footwear, Processed Foods and Semiconductors. From our analysis, if we understand that a company in the Commercial Banking industry is investing heavily in Data Security, we view this as long-term positive for the firm, as opposed to a drain on investment capital.

The SASB Materiality Map® allows for further understanding the specific metrics that illustrate performance on a disclosure topic for a particular industry. In addition, our team is able to use the SASB Materiality Map® as an ongoing discussion framework for corporate engagement, in an effort to understand if a company is moving in a positive direction in terms of its sustainability and ESG investment.

The guidance and information provided by the SASB Materiality Map® allows the Applied Equity Advisors team to be efficient with its resources and spend time on what matters, or is truly material to the desired outcome. Given the evidence provided, we expect integrating ESG into our investment process to be additive to portfolio results.

ESG integration in the material world

Compelling research shows that a focus on ESG factors has the potential to improve investment results. The Applied Equity Advisors team integrates sustainability analysis into its stock selection by focusing on those ESG factors that are material to the companies that we are evaluating.

In all, we believe our integrated ESG approach will continue to drive good corporate citizenship, while helping investors thrive in the material world of ESG investing.

This represents how the portfolio management team generally implements its investment process under normal market conditions. Past performance is no guarantee of future results.

Risk Considerations

There is no assurance that a portfolio will achieve its investment objective. Portfolios are subject to market risk, which is the possibility that the market values of securities owned by the portfolio will decline and may therefore be less than what you paid for them. Market values can change daily due to economic and other events (e.g. natural disasters, health crises, terrorism, conflicts and social unrest) that affect markets, countries, companies or governments. It is difficult to predict the timing, duration, and potential adverse effects (e.g. portfolio liquidity) of events. Accordingly, you can lose money investing in this portfolio. Please be aware that this portfolio may be subject to certain additional risks. In general, **equities securities'** values also fluctuate in response to activities specific to a company. Stocks of **small-and medium-capitalization companies** entail special risks, such as limited product lines, markets and financial resources, and greater market volatility than securities of larger, more established companies. Investments in **foreign markets** entail special risks such as currency, political, economic, market and liquidity risks. **Illiquid securities** may be more difficult to sell and value than publicly traded securities (liquidity risk). **Non-diversified portfolios** often invest in a more limited number of issuers. As such, changes in the financial condition or market value of a single issuer may cause greater volatility. **ESG** Strategies that incorporate impact investing and/or Environmental, Social and Governance (ESG) factors 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. As a result, there is no assurance ESG strategies could result in more favorable investment performance

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