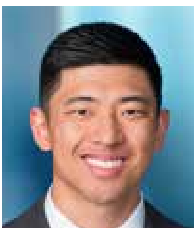
Fiduciary Trust International

Investing with Purpose: Making Sense of ESG, SRI and Impact Investing

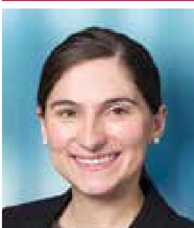
INSIGHTS

Many investors want to bring their portfolios into alignment with their personal values, but don't know where to start. This *Insights* outlines the three most common approaches.

CARIN L. PAI, CFA®
Executive Vice President, Head of Portfolio Management



MICHAEL FIRESTONE
Managing Director, Portfolio Manager



NATALIA LAZAR-GALOIU
Senior Investment Associate

A growing awareness of environmental and social issues, along with the availability of data on corporate responsibility, is changing the way individuals think about investing. Increasingly, investors are bringing their portfolios into alignment with their personal values.

There are many different approaches to "responsible investing" and they go by different names—including ethical, sustainable and green investing. But they all have one thing in common: They pursue financial rewards while encouraging positive changes in the world.

Doing Well Financially While Doing Good Socially

Traditionally, investment decisions have been aimed at achieving financial goals, using research on economic trends and analyzing a company's balance sheet. If investors wanted to also promote positive change in the world, they typically turned to philanthropy, donating money to worthy charities associated with causes they supported.

The rise of responsible investing is providing a way for investors to pursue both avenues at the same time. With more information available about which companies are making the most progress in this area, investors can find a comfortable place on the spectrum between doing well financially and doing good things for the world.

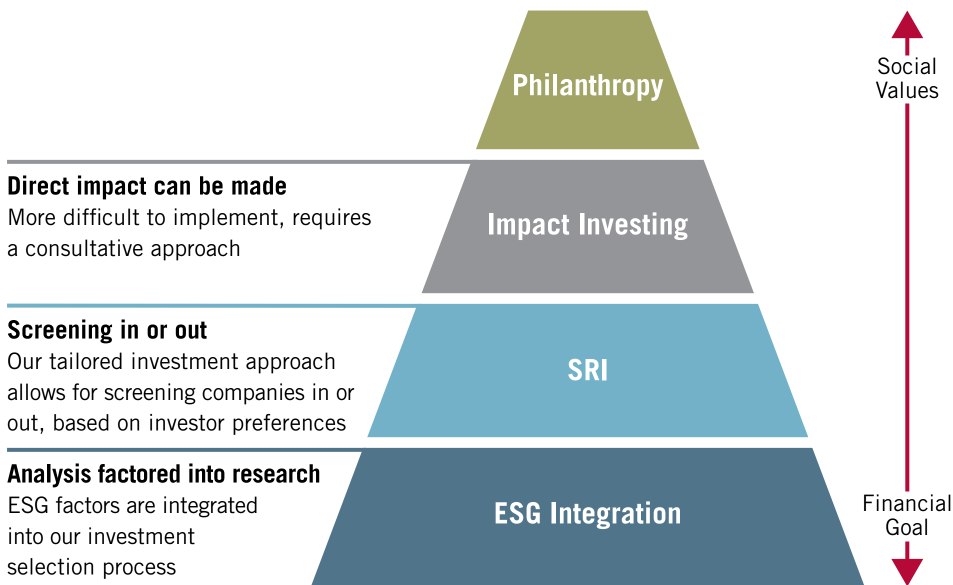
Three Common Approaches to Responsible Investing

Responsible investing means different things to different people, and there is a broad spectrum of approaches. But the most commonly used techniques are ESG, SRI and Impact Investing. The approach investors take depends largely on their personal preferences and which part of the spectrum they find most appropriate—depending on how heavily they want to lean toward achieving financial goals versus promoting social causes.

Environmental, Social, Governance (ESG)

Environmental, social and governance (ESG) is the most common approach, using sophisticated analytical tools and Big Data to assess a company's efforts at promoting sustainability—pursuing long-term growth without putting the environment or economy in jeopardy for future generations. ESG criteria are incorporated into the overarching security-selection process.

Building Social Values into an Investment Portfolio



Making the Grade

ESG investing is based on data provided by rating agencies, which grade each company on a wide range of factors related to environmental, social and corporate governance. Some ESG factors, such as executive compensation and human rights, have played a pivotal role in security analysis for years. Others, such as protecting personal information, have gained significance more recently. All of these factors may have an impact on the company's financial performance.

Ultimately, each factor seeks to answer simple questions.

- **Environmental Factors.** How does a company manage its impact on the environment (e.g. waste disposal, carbon emissions and other practices that affect air and water quality), and how might that affect its profitability?
- **Social Factors.** How does a company manage its relationships with employees, suppliers, customers, and the communities where it operates?
- **Governance Factors.** How is a company's oversight structured, such as board diversity, gender compensation and avoiding conflicts of interest?

Answers to these questions enhance the investment decision-making process by providing information that complements traditional financial analysis.

Favoring Firms with Higher ESG Scores

ESG factors play an important role in understanding a company's exposure to risk and how that relates to potential investment returns. ESG analysis strives to gain an awareness of factors that might impact a company's financial performance and identify players that stand out from the crowd.

At Fiduciary Trust, we integrate ESG factors into our standard research process as well as portfolio construction and ongoing review. This data is used as part of our search for best-in-class companies with forward-thinking management teams, strong corporate cultures and social awareness. Within each industry, we favor companies with higher ESG scores compared to their peers.

Better Business Practices, Higher Quality Companies

In our view, ESG investing should not require a tradeoff in performance. In fact, a growing body of evidence indicates that incorporating ESG factors into the research process may offer long-term performance advantages.

The US Department of Labor recently weighed in on the topic, explaining that ESG factors are proper components of a fiduciary's responsibility to thoroughly analyze all investments. As such, ESG investing does not conflict with a fiduciary's responsibility to maximize investment returns.

Companies with management teams that recognize the importance of ESG in the marketplace often have a greater awareness of potential risks that could one day become financial disasters, so they can manage them more effectively. Also, companies that are socially conscientious tend to incorporate business practices that contribute to long-term success, such as gender diversity on senior management teams and meaningful community involvement.

Socially Responsible Investing (SRI)

Socially Responsible Investing (SRI) places a finer point on personal values by actively pursuing ethical, environmental or social objectives alongside financial goals. To implement SRI in a portfolio, investors must have the ability to personalize their

portfolios by including or excluding certain companies, sectors or countries, for example, to reflect their personal social values.

Positive and Negative Screening
SRI strategies may incorporate positive or negative screens based on a set of values-based criteria identified by an investor. For example, an SRI strategy might screen out "sin stocks" like alcohol, tobacco, or gaming, while screening in companies that promote positive changes in society.

Eliminating a security, industry or particular country may make sense for an investor who has an overriding personal belief that takes precedence over other considerations, such as diversification or potential returns.

For example, an investor may have a strong desire to support environmental efforts. Therefore, it might be reasonable to invest a portion of the portfolio in an industry such as renewable energy, despite a limited number of investment options and higher risk.

Portfolio Returns May Be Affected
Decisions on screening in or screening out certain securities can be complicated. Depending on the approach, SRI strategies have the potential to reduce returns by shrinking the investing universe or increasing risk by over-allocating to certain categories. These decisions should be thoroughly evaluated and discussed before being implemented.

At Fiduciary Trust, portfolio managers help clients understand the potential benefits and risks associated with any SRI filters. In many cases, we find a compromise that satisfies an investor's social concerns while preserving the financial integrity of the portfolio.

Impact Investing

In a broad sense, any approach to responsible investing can have a positive impact on society. But pure impact investing is a specific strategy that aims squarely at making the world a better place.

Impact investing is therefore the most difficult of the three strategies to implement, and can carry significant investment risk. Investments are often focused on smaller, private companies and community groups working to solve specific social or environmental problems, sometimes by providing working capital to underserved communities or focusing on a theme such as sustainable agriculture, renewable energy, conservation, housing, healthcare or education.

Another way to implement impact investing is by actively engaging with public companies, through proxy voting or involvement with management teams, to effect change in the organizations.

Finely Tailored, Carries Higher Risk
Because this strategy is so complex, our approach to impact investing is highly tailored and consultative. For clients who are interested in this approach, our portfolio managers and estate planning professionals offer guidance on the best approach for your entire financial well-being.

Often, our clients find that the best way to make an impact in the world is through philanthropy. A broad array of charitable giving strategies— including private family foundations, charitable trusts, donor advised funds and other tax-efficient approaches to philanthropy— can help achieve this goal.

Investing in a Sustainable Future

Investing responsibly has come a long way in recent years as demand grows and ESG data becomes more easily accessible. According to recent estimates, almost 85% of S&P 500 companies now release data about their sustainability efforts on a regular basis.

While efforts are underway to develop a uniform set of ESG reporting criteria which could further simplify the due diligence process, there are still several limitations, including guidelines from third-party research firms that can vary significantly. Transparency and data integrity is also an issue, as self-reporting on many ESG factors can be spotty.

Finally, the ability to completely eliminate a certain type of investment from your portfolio, including companies directly and indirectly associated with a specific issue, might be limited. And measuring the true impact of your investment choices is difficult at best.

With these caveats in mind, we encourage investors to embrace responsible investing with guidance from financial professionals who understand its complexities as well as your entire financial picture.

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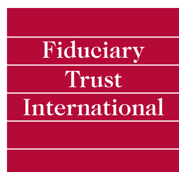

fiduciarytrust.com

Fiduciary Trust International Offices

New York, NY
(877) 384-1111

Arlington, VA
(703) 647-4132

Boca Raton, FL
(561) 988-8460

Coral Gables, FL
(800) 618-1260

Fort Lauderdale, FL
(561) 988-8460

Los Angeles, CA
(800) 421-9683

San Mateo, CA
(877) 284-2697

St. Petersburg, FL
(800) 618-1260

Washington, DC
(888) 621-3464

Wilmington, DE
(866) 398-7414

Fiduciary Trust Company of Canada Offices

Calgary
(800) 574-3822

Toronto
(800) 574-3822

FTCI (Cayman) Ltd.

Grand Cayman
(877) 384-1111

(212) 632-3000
(calling from outside the US)

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