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WEALTH MANAGEMENT

Your **Active Wealth**
Podcast

Earth Day Edition: Sustaining Wealth Through Responsible Investing

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Featuring:

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VO [00:00:01] Is your wealth strategy supporting your long-term goals? Welcome to *Your Active Wealth* with BNY Mellon Wealth Management, where we offer insights that can help you move closer to your goals. We'll tackle timely topics through the lens of the five pillars that comprise our Active Wealth framework: Invest, Spend, Manage, Borrow and Protect, and provide guidance on navigating the unpredictable, to help you build and sustain wealth.

Alicia [00:00:30] Hi, everyone. I'm your host, Alicia Levine, head of equities, trading and capital markets advisory at BNY Mellon Wealth Management and welcome back to *Your Active Wealth*. Today is a very special edition of the podcast as we're releasing it on Earth Day, which is April 22, 2022. Earth Day was originally started in the U.S. since 1970, with the goal of raising awareness of environmental issues facing our planet. Over the decades, it has grown into a major international event, engaging more than one billion people every year. The theme this year in 2022 is, “Invest in our planet”, which is particularly relevant to our industry and to our podcast today. In recent years, more and more individuals are interested in making an impact with their investments. They want to partner with companies that align with their values. And appreciating that connectedness between the climate and the broader inequities that has investors wanting to know more. And they want to put their dollars and capital into investments that meet their responsible investing parameters. Simultaneously, people want competitive returns that meet their wealth goals. So today we're going to tackle these issues and how investors can achieve these ambitious goals. I'm happy to welcome to the podcast Sinead Colton Grant, Global Head of Investor Solutions, and Karen Wawrzaszek, Washington, DC Regional President at BNY Mellon Wealth Management. So everyone, thank you for joining me today. I'm very excited about this conversation. It's a hot topic for many of our investors and really throughout the investing community. But you know, when you think about terms out there like responsible investing, impact investing, ESG, which is environmental, social and governance, sustainable investing, there are a lot of terms out there. Can you help us understand what these terms mean and clear up some of the confusion?

Sinead [00:02:40] Really at its essence, it means investing according to an institution's or an individual's value, and this does feel like somewhat of an acronym proliferation. But often it's aligned with one or more of the UN Sustainable Development Goals, the SDGs. And for clarity, the SDGs are the 17 globally set goals that were adopted by all UN member states back in 2015. And so it incorporates many different aspects, but ultimately recognizing that ending poverty is directly linked to solutions that improve health and education outcomes, a reduction in inequality and that all in addition to tackling climate change. So very often through this lens, you will see investments that are aligned with certain SDGs. And of course, ultimately solving for those challenges should ultimately lead to stronger economic growth. And when we think about responsible investing, we tend to think about investing in four categories. So we have screening, which can be positive or negative. The original was negative screening, so excluding sin stocks, for example. But you can also have positive screening, where you may want to positively screen to include firms that have greater than 30% diversity in their board. The second category is integration, where the approach is really fully integrated into the investment process, and that's really where there's a more holistic lens applied to all risks that could impact an investment. And very often you see this tied to active engagement with firms in certain areas. The third category that we think about is thematic, where it's focused in a particular segment or a particular vertical. So, for example, an investment solution that's purely focused on clean energy and companies associated with that space. And the final one is impact investing. This is where we're focused on financial returns, as well as a measurable and additive effect in whatever the particular area is that the solution is focused on. Typically, we think this is predominantly found in private markets where you can have that direct alignment. But for us, thinking through where

in those four categories might a solution sit really helps to clarify some of what is a very extensive range of investment options that are out there.

Alicia [00:05:23] Sinead, that's great that you broke that out for us because I know that investors who are interested in responsible investing have looked at a lot of products, and these products are really labeled all over the place: responsible, sustainable, ESG and/or impact. And given the way you've talked about the different goals and the different ways of doing this, how can investors be sure that their investments truly are responsible?

Sinead [00:05:51] It's a very important topic. And frankly, for an individual investor working in isolation, it's very challenging. We can simply look at one of the very significant data points from the last couple of months where Morningstar, and Morningstar is obviously a very well-resourced firm, they actually culled over a thousand funds from the list that they had created of sustainable investment funds in Europe. What they did in order to make that determination was a very extensive review of the fund documentation. So the fund disclosures, the prospectuses, annual reports, and that impacted funds that managed 1.4 trillion dollars. It was 40% of the fund universe that they have. And I mention this because, yes, it's a very significant number, but it's a positive sign because the industry is getting more experienced at getting stricter around the classifications. And, for example, in our manager research process, for every manager who claims that they offer a responsible investing solution, there is an additional set of criteria that we require that solution to meet. And the questions that that we ask the manager have really been developed to ensure the solution is very much aligned with the responsible investing goals that are stated. I think it's very, very difficult to do on an individual basis. You really need to have some framework through which the vetting takes place. We're seeing the ability to describe a fund as investing sustainably or being ESG-focused in Europe, which is a little ahead of the U.S. They're getting much, much stricter. They're introducing regulations around this. I think that's something that we will see in the U.S. in due course.

Karen [00:07:43] One of the things I wanted to add to that, because it's very important, is on the individual investor perspective. And the thing that you end up seeing quite a lot of is an initial investment in something, in an idea, that is to achieve one of the goals, and agree with Sinead on the 17 United Nations Sustainable Development Goals. But it's a matter of an individual investor not able to maintain the rigor and the discipline and following that investment all the way through to its successful outcome of the goals outcome. And certainly in a timeline that meets an investor's individual goals from other financial metrics. So not just the impact goals, but ensuring that it's lined up with other cash flow needs and other financial needs that are happening in their lives, consistent with the timeline of that particular investment or fund's goal, and having support or a partnership that helps provide the rigor and the data, ensures that they stay the course with that investment and achieve the outcomes that they're meant to.

Alicia [00:8:47] So Karen, I want to ask you what I think is a tough question, and I think what's going on geopolitically is raising some of the issues about the global shift from hydrocarbons to clean energy and the costs associated with that is really bringing it to the fore. A lot of people and some of the critique about ESG and responsible investing is that it leads to something which we like to call greenflation. So it's very expensive to make these kinds of investments. And in the end, the path to a greener energy future can be very expensive that requires enormous amounts of investment from governments, as well as from individuals being willing to pay up for a newer technology. So Karen, can you talk to us about what the costs and the ramifications are of such a transition?

Karen [00:9:42] That's such an excellent hot topic right now because it's preventing people from taking some action. And I like to think of it in two camps. There's this deferred maintenance perspective that is part of the price to pay now because we are coming a little bit late to the party, especially in the U.S., different than Europe for sure, and driving some of those commodity prices up, the runway necessary to be able to get to a greener place and get to temperature parity, for example, is far longer and the upfront costs are far higher now. But the rewards are 30 or even 50 years from now, and that's a really hard thing for investors to appreciate and bear the costs. And so it's a lot of why there needs to be supports from the entire ecosystem of, and you mentioned governments, other large private enterprises and individuals. And you're seeing that now, those partnerships now, trying to help pull that cost curve down a bit so that the investments can be made. And I hope that we'll talk about it in this program as well. But when you have major events happening you feel in real time the effects of not making the investments and not having made these investments 10, 20, 30 or more years ago. And so that comes with a really high price to pay right now because we're constraining that inventory that it takes and that's driving those prices up and hence inflating what it costs to become green, to make it very simple. And it's really matching this runway of investment timeline. And it takes all of those stakeholders in that ecosystem that I mentioned to kind of come to an agreement and make those investments today.

Alicia [00:11:31] It sounds reasonable that this kind of transition can take something like 30 or 40 years. How do we ask investors to have a timeline like that? How do we construct products that have a timeline like that?

Karen [00:11:45] It's not done in isolation, right? And so if you think about investments and this is very much Sinead's world in actually identifying solutions and they are happening in parallel, right? So companies trying to kind of unwind and reinvent into new systems to be able to get there. It's not stranding assets to be able to get there. And we saw the error in that approach as recent as 10 years ago and five years ago. And so it's really this parallel process. And so if you're invested in a part of that and you're moving forward as you're reinvesting into renewables and other green energies that are supportive of that 50-year timeline, and I do think it's a 50-plus year to get there and you can see even the United Nations recalibrating that clock every few years to meet new goals. Because we have extreme events like we're facing now that are again pushing that out a little bit longer to get to some of those carbon emissions and temperature parity goals. And so that's going to take some staying power, but it's going to take very much parallel investment to get there.

Alicia [00:12:59] So, Sinead, I want to specifically bring up the war in Ukraine because I think there's been a lot of focus on the transition to cleaner energies, perhaps the dependance of European countries on Russia for their oil and gas needs, leaving them more exposed because they were not energy independent. Can you talk to us about how this specific crisis has changed the conversation about responsible investing and the transition to cleaner energy?

Sinead [00:13:31] It's a really important discussion because in hindsight, I think we're all recognizing that so many of the paths that have been laid out towards moving in a greener direction towards renewables were predicated on assuming that the geopolitical environment is stable or at least the geopolitical environment in the direct orbit of, for example, countries in Europe, was stable. I mean, first and foremost, this is a humanitarian crisis. I think we cannot even broach the topic without recognizing that. But where this translates into the discussion around the move towards greener energy is that for many countries in Europe, the first step in that process was moving away from burning coal, towards natural gas as an interim step. Nuclear energy is not hugely popular in Europe for many reasons, but natural gas was that link. The challenge here is that most natural gas that Europe uses comes from Russia. The biggest pipeline, Nord Stream, well effectively Nord Stream 1, runs from Russia to Germany, and that is a massive issue because obviously it becomes a bargaining chip in the geopolitical situation that we're in at present. But the conversation that's happening in many countries in Europe is now around well, how do we manage this transition? Maybe natural gas is not the interim step we thought it was. That could potentially lead to a situation where coal is the energy source for longer. Obviously, we're having some liquid natural gas that's being shipped to Europe from the U.S. and other places, but it's a major recalibration. The end goal remains the same, but the steps that are palatable in the interim have changed. And I think this really makes us consider holistically how we develop those paths, recognizing that situations that we thought were really set in stone may not be. You know, we always think more broadly from an investment perspective, what's the risk? What are the things that could impact my portfolio and positioning that are, you know, perhaps very low probability, but if they were to occur, have a very significant impact. And I think this is what we're seeing right now. So this is not a simple answer. It's a very significant recalibration and it involves tradeoffs. How long are we willing to burn a fossil fuel that we were actively trying to transition away from in order to get to a better place longer term?

Alicia [00:16:50] I would assume that in many ways that it increases the urgency for greener investments and for more transition investments in order to move away from that kind of dependance. So perhaps an overlap for a while. But, you know, it just feels like the crisis has perhaps propelled the urgency here in order to get to a greener and less hydrocarbon world. Would you say that's about right, Karen?

Karen [00:17:21] I think that's right. One of the things that's interesting that you touched on in your opening, Alicia, is this interconnectedness. So we're celebrating Earth Day and we're talking about climate action and becoming greener, which involves water and the planet. But what this event has really highlighted is the domino effect on the human condition. So in order to accelerate energy independence and again, I think it actually bifurcates the world a little bit greater than we originally probably thought. The U.S. being very different in land mass and natural resources than say, Europe, as Sinead very accurately points out. But it's this trade off, what do we sacrifice in the other inequities of the humanitarian piece that we highlighted a moment ago? And as it relates to water and shelter and education and workforce that are natural side effects of trying to solve for only one thing, and I think that's what this this moment in time has really called out is how do we accelerate in our energy independence without more suffering because it does come at a cost and we have to kind of stack rank what that is and we have to accelerate policy that actually support getting there. And that's on the table right now. So even at least in the U.S. is how do we actually think about the

United States’ natural resources and get to some partnership in allocating those a little bit differently so that we aren't so dependent, but they are interconnected very much.

Sinead [00:19:00] I think the other piece that comes through with this and what really remains to be seen is how the macro meets the micro. And the example here is one of the things that certain parts of Europe have a lot of is wind, which can be harnessed for energy. If you look at Denmark in particular, they were very early adopters here. But when you look at the adoption of the ability to harness wind energy in different countries in Europe, it's much patchier, and often what tends to happen is that individual citizens agree with the concept in general, but they don't want a windmill anywhere near where they live. So I think we may start to see a greater realization that the move towards cleaner energy involves everyone and those tradeoffs happen at the micro level as well. So perhaps you may see less resistance to putting those windmills in place, which is never going to be the primary energy source, but it could be an important incremental source in certain situations.

Karen [00:20:12] I'd add to that too Sinead and it's the not in my backyard syndrome. And for sure, in the U.S., we have embraced that across a variety of issues. But think about transit and think about infrastructure and redesigning infrastructure around smart cities, designs that also think about that reallocation of resource and concentrating that better. And that's been a challenge in the United States because of its geography and I don't want rail in my backyard or near me for lots of reasons of sound and people congregating. But we will have to, at the micro level, accept some of those changes in proximity to where we are.

Alicia [00:20:54] So I think it's really interesting that we're contrasting the U.S. with Europe on policy, but I want to take that a little higher up and talk about the difference between U.S. and Europe on investing. You know, Europe is about 15 years ahead of the U.S. when it comes to impact and responsible investing, and it kind of came to the U.S. through the big pension plans who started allocating to more responsible and ESG investing. And it's really trickled through to foundations, families and the retail investor as well. Sinead, why do you think there's been a difference in the timing of why Europe embraced this kind of investing much earlier than the U.S.?

Sinead [00:21:35] It's a great question. And by the way, the journey was the same in Europe, with some of the very large quasi-sovereign funds in Europe, particularly those in Scandinavia being the first movers. I think there were a couple of reasons. One, just the direct impact, so economies or countries feeling a direct impact from climate change. And so that helped to push it up the agenda earlier.

Alicia [00:22:03] Which explains why the sovereign wealth funds were first involved in it because it was a governmental issue.

Sinead [00:22:09] Correct. Exactly. So you're right, the history is much longer in Europe, and that leads to certain things, such as regulation being farther advanced in Europe and in this specific area of responsible investing. But what we're seeing is that the U.S. is catching up really quickly. So the rate of adoption is faster in the U.S. over the last couple of years. We're also seeing that there is a leap straight into integration or impact or thematic solutions or investing, rather than the stepping stone of exclusion, which is really where a lot of these solutions started. I think what's also interesting is you do see some regional variations as well in terms of the areas of interest because Europe is not exclusively but predominantly focused on the energy transition and the impact of climate change and solutions that are really focused in those areas. Whereas what we increasingly hear in the U.S. is that investors are equally focused on equity and considering how all of the issues related to equity, whether it's social justice, poverty alleviation, there's a much greater focus on that in the U.S. than at least has been seen to date in Europe.

Karen [00:23:46] I'd love to add to that because one of the things that I think explains that kind of being born and raised here and part of the system is the differences in baseline supports between the two geographies. And so in Europe, there's different kinds of pension and supports in retirement, there's different kinds of free education. The barriers to entry to certain ways that we've become wealthy or even able to care for ourselves and move up Maslow's hierarchy of needs is very different. And so the social lens in the U.S. and when I'm out talking and working with people, it's equal. It's I care about the environment, but I also want to solve all of these poverty, education and workforce issues because if I don't take care of self and community, the rest doesn't matter as much. And so just flipping that script a little between the two geographies, I think is a big reason. So from a social supports we aren't a country that really has traditionally lent a lot of social supports or easier entry into capital markets or work or education. They're all paid for privately. And that informs some of the inequities, right? And so it's hyper focus for U.S. investors that are interested in values and impact investing, that is.

Alicia [00:25:10] So I have to ask you the big question that sort of hangs out there for a lot of people when they first consider ESG or impact investing. And that's really the issue of returns. A lot of people will say, well, look, it's terrific to invest along with your values, whatever they may be. But can I achieve as good as or better returns compared to traditional investing? And I'm hoping you can help our audience here understand whether investors sacrifice returns.

Karen [00:25:42] I think one of the big changes you've seen over the decade early on, the field did get painted with that brush of concessionary returns and largely due to negative screening. When you eliminate entire food groups, you don't perform as well if that food group is the performer. So take energy. You fast forward where it's now more of an engagement strategy. And not only that, it's actually a risk management tool. So companies are performing and these investments are performing because in part, it's a risk management tool and it actually identifies that you've done scenario planning. You've got vertical alignment inside of your organization that will sustain as a business, sustain and not have the going concerns that other enterprises might have that aren't looking at some of these issues and asking critical questions that are climate oriented, that are governance oriented, that are social oriented. And so that has changed dramatically in the approach to it, which has, I think, now comparable performance, and the data does support that.

Sinead [00:26:47] So I would agree. I mean, there's been an evolution. I think the first piece is it's a more holistic lens on risk. And the thing that we know as investors is that smaller drawdowns are easier to recover from. And when you add on to that, the power of compounding, you should be able to generate, all else being equal, higher returns over time or at least equivalent if your responsibly oriented strategy is generating smaller drawdowns. And we've actually seen that with a number of episodes of market volatility over the last few years. But ultimately, it's about investing in alignment with your risk tolerance so you understand how those investments potentially will behave at different points in time and importantly, that you have the confidence and comfort to be able to rebalance your portfolio towards those strategic goals when there are opportunities to do so. I think also, you know, we have to recognize that in many ways there will be technology developments, potentially even new industries that form that are much more integrated with reducing environmental impacts. And those are going to be really interesting to investors. So I think there has been such an impact from the negative screening, which, you know, when you go back decades and it was a very, very blunt tool. But yet those are the solutions that have the longest track record. And to Karen's point, when you're just excluding with a very broad brush, you would anticipate that's going to have a negative impact over the long term on your returns. But what we're talking about today is very, very different. We have any one of a number of examples in recent years of individual companies where if you understood how they were managing their sales practice. If you understood how they were managing safety practices, you would have had a very different view of them as an investor. And I think ultimately that's where we're trying to get to with many of these more responsible investing solutions. It's a more holistic lens on risk, which ultimately should benefit an investor.

Karen [00:29:21] The other thing I'd add to that, too, is the staying power of an investor. So no different than traditional investing, those investments that you're not going to apply this discipline to, you need to stay invested and see some of those ideas come through. Understanding where the risk is going to intersect in that particular investment and being able to kind of weather that and understand and appreciate that it needs 10 years, especially in the area of getting to renewables and as we talk about climate today. And other ideas may be shorter, but kind of treating no different. Coming in and out of ideas because you haven't identified and matched your risk tolerance for any investor is going to not yield returns.

Alicia [00:30:08] So that's really interesting. And I love thinking about responsible investing as a way of measuring risk tolerance and embracing it and really thinking about analyzing companies in a more holistic way. I think it's a great way of talking about it and thinking about it. This has been such a useful discussion today. Really interesting in the moment we're in on the day that we're doing this on April 22nd. I'd love to thank both Sinead and Karen for joining me today. If you'd like to learn more about sustainable investments that can meet your needs, I encourage you to reach out to a BNY Mellon wealth manager. Again, I'm Alicia Levine, thanks for joining us and we'll see you on our next episode of *Your Active Wealth.*

VO [00:30:54] Thank you for listening to this episode of *Your Active Wealth*. Be sure to subscribe to this podcast on Apple Podcasts, Spotify, Google Podcasts or Stitcher and visit bnymellonwealth.com to view the latest insights on the subjects that matter most to you.

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