Responsible Investing Demystified

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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.

Ben [00:00:30] Hi, I'm your host, Ben McGloin, head of advice, planning and fiduciary services at BNY Mellon Wealth Management, and welcome back to *Your Active Wealth*. Today's episode is especially timely as it launches on Earth Day, an annual event that demonstrates support for environmental protection. It was first held on April 22, 1970, and now includes a wide range of events that involve 1 billion people in more than 193 countries. The official theme for 2023 is "Invest in Our Planet," which is an appropriate theme for today's podcast as we're going to be discussing responsible investing with an expert on the subject, Manisha Ali.

Manisha is Head of Responsible Investing at BNY Mellon Investor Solutions and has close to two decades of industry experience and expertise in Responsible Investing. She has authored various publications and is a frequent speaker at educational client events and industry conferences on ESG, Impact and Responsible Investing. Manisha has worked closely with many institutional, intermediary, and individual investors having begun her career in Singapore, and subsequently working across 14 countries in the Asia Pacific in business management, product development and institutional sales. Manisha has earned an MBA from Columbia University as well as both Undergraduate and Master's Degrees in Computer Science from the National University of Singapore. Manisha, welcome to the podcast.

Manisha [00:01:48] Thank you, Ben. Appreciate you inviting me to this conversation.

Ben [00:01:52] Manisha, to start off for the benefit of our audience, let's take a moment to level set on some of the terms that are often referenced when discussing Responsible Investing. Confusing terms like ESG investing, sustainable investing, impact investing, and many, many more. Can you share how you define Responsible Investing?

Manisha [00:02:09] Yes, absolutely Ben. You are very right in acknowledging the alphabet soup that exists in the industry as it relates to the myriad of approaches and terminologies that exist to reference the space. At BNY Mellon, we use the term "Responsible Investing" to encompass all approaches that investors take to incorporate the sustainability preferences in their investment portfolios. A helpful way to think about responsible investing in general, is to drill down on what are the motivations or drivers behind investors coming to the table. In other words, what are they seeking to do? We think of it in three simplistic ways. Investors are sometimes coming to us and requesting incorporation of their personal beliefs and values in their investment portfolios. Or, they are looking to incorporate environmental, social and governance issues from a financial materiality perspective in their portfolios. And finally, there is increasingly a trend of investors looking to incorporate impact outcomes through their investment portfolios. We'll go through a little bit more in detail in each of these areas, but in general, Responsible Investing for us is about meeting clients' needs, understanding where they're coming from and thinking through what are the most reasonable approaches to implement or incorporate those values and preferences in the portfolios.

Ben [00:03:51] I know often investors assume that Responsible Investing, Manisha, necessitates more of an exclusionary approach. But I think based on what you just heard, it sounds like there is more to responsible investing. Can you elaborate on that?

Manisha [00:04:04] Sure. It's accurate that a lot of individuals and institutions sometimes think of ESG or responsible investing from an exclusionary perspective. And that is because if you think back to the inception of the space, going back to even the 1700s or more recently, the mid-1900s, it was all around incorporating whether it was religious beliefs and values, think of the Quakers and the Methodists. Or subsequently political beliefs and values, think apartheid movement. For a long time, it was around incorporating personal, religious, and political values and beliefs in investment portfolios.

Fast forward, I would say in the late 1900s, there was increasingly an acknowledgement of environmental, social and governance issues having an impact on company performance, particularly in a longer-term time horizon. And that is where this concept materialized around considering ESG issues or environmental, social and governance issues from a financial materiality perspective. And this is what led to the creation of the United Nations-backed Principles of Responsible Investment, which is a membership-based non-profit that today has 4,000 plus signatories comprising asset managers, asset owners, as well as service providers that are committing to six voluntary principles, one of which is that as fiduciaries we are going to consider which environmental, social and governance issues could impact investment selection and portfolio construction. In the evolution of this space, this idea of ESG integration became more acknowledged and gained momentum. And then finally, this is not a recent implementation approach. It goes back to again the late 1900s, where the likes of the Ford Foundation and Heron Foundation launched the idea of doing impact investing through their programmatic dollars. According to the Global Impact Investing Network, impact investing assets globally are estimated to be $1.16 trillion as of December 2021.

Ben [00:06:25] Wow, that's a fascinating and interesting historical perspective. And you go back to the 1700s. Can you speak to some of those, what I'll call, notable industry trends today that are really driving responsible investing and the driving forces behind responsible investing today?

Manisha [00:06:40] Sure, Ben, there's a few long-term drivers that I would attribute the evolution of this space to, one which we've talked about already, which is around investor interest. Whether it's individuals, whether it's institutions, increasingly coming to their financial partners and seeking to incorporate their sustainability or impact preferences or values in their investment assets. I mentioned the PRI signatories number earlier. The U.S. Forum for Sustainable and Responsible Investment here in the U.S. also tracks AUM linked to sustainable and responsible investing, and their most recent number was $8.4 trillion domestically here in the U.S. In addition, we from time to time do studies of next gen interests. And we have seen in our most recent report in partnership with Camden Wealth that next gen is highly interested in sustainable investing. In particular, I would point to some stats, 56% of next gen currently invest sustainably and 68% assert that it is a permanent part of their investing. I would also point to a few recent drivers for the unprecedented pandemic that we've all been through. Heightened social inequity issues and an ensuing global geopolitical crisis which have arguably all increased investor interest in utilizing at least a part of their investment capital and driving solutions or services that meet global sustainability challenges. So that's the first one.

The second driver would be companies or corporate America, increasingly recognizing that sustainability issues are business issues and can be drivers of value creation for shareholders and can have an impact on long-term company performance, whether it is efficient use of natural resources, talent management, human capital management practices and policies or strong governance. All of these have an impact on long-term success and companies are increasingly recognizing that in order to be competitive, they need to consider these aspects as part of their long-term business strategy. And one proof point I would point to is that as of 2020, 92% of the S&P 500 companies now publish a sustainability report.

The third driver I would point to is regulatory developments. There certainly has been a push from a regulatory perspective for mandatory and standardized disclosures around sustainability considerations. We're seeing proposals around this all over the globe and I would argue that's in the right direction and trying to give investors access to accurate information to be able to make decisions around what's material for a particular company. And from a policy perspective, the other example I would point to is, for example, domestically, U.S. recently passed the Inflation Reduction Act, which is seen to be another tailwind for private capital investments domestically, whether it's around clean air and energy initiatives, investments and environmental and justice projects to help underserved communities, as well as other projects targeted at reducing emissions in the U.S. Across the pond, we've seen the European Green Deal launched in 2019 that also has some similar objectives and policies for reducing emissions, preserving biodiversity on investments and other solutions to fight climate change. So these developments all will likely result in more investable opportunities for investors and continue to drive interest.

And finally, we're seeing secular growth trends across various industries that are directly linked to sustainability. If you think about greening of transportation, decarbonization of the grid, access to health, demographic changes. These are all trends impacting all of the entities and stakeholders that I mentioned earlier and arguably will continue to drive company interest, policy changes as well as investor interest and different forms of responsible investing.

Ben [00:11:10] So Manisha as you've referenced, Responsible Investing has grown steadily for a number of years. However, recently the space, in particular the reference to ESG investing, has come under a lot of scrutiny. Could you share your thoughts on this?

Manisha [00:11:21] Yes, absolutely. Look, I think what used to be a niche area of investing over the past decade gained rapid popularity. And as the industry drivers that I described earlier have resulted in higher proliferation of product and higher investor interest, certain challenges have also simultaneously emerged. First, there are no standard definitions of what things mean, as we talked about earlier. Secondly, there is no standard disclosure of ESG information by companies, and I talked about it earlier that we're moving in that direction. But that basically means that today we are largely looking at mostly unaudited self-disclosed and sometimes backward-looking information which can be limiting. And thirdly, there really were no guardrails as it relates to how things were being or how solutions were being labelled and marketed.

For that reason, I think what we're going through today is growing pains, and I see it as an inflection point where the regulatory intervention and the debate around what is meant by ESG and what labels products should justify, are frankly necessary and helpful for the longer run. This inflection point reminds me of a book by Geoffrey Moore called *Crossing the Chasm*, which was in reference to marketing techniques for successfully mainstreaming early technologies. But the concept still applies to other industries and spaces as well, including Responsible Investing. What is important to note here, though, is regardless of what things are called and semantics and terminology, it's important to separate the idea of financial materiality from values-based investing and impact investing. As we discussed before, there is not a single approach or method of implementing Responsible Investing and whether you call something ESG or not, prudent investment management and fiduciary duty calls for understanding material risks and opportunities that could impact long-term financial performance. And depending on the sector and business model or the geographical presence of a company, different environmental, social and governance, or if you would call it more general sustainability issues, would be material. This is very different from incorporating values and excluding certain sectors or industries, which is essentially a client-directed decision and could have an impact in terms of expected risk and return of the portfolio based on what and how much is excluded. In turn, this is different from the approach of investing for intentional positive outcomes, which requires a very keen eye towards understanding, evaluating, measuring and reporting on the expected impact goals of a strategy. So, in a nutshell, to summarize, I think what we're going through is necessary for a sensible future evolution of different forms of Responsible Investing.

Ben [00:14:37] That's great and I'd love for you to share a real-life example of Responsible Investing being put into action. And perhaps given that we are celebrating Earth Day, an example related to investing in our planet would be insightful for our audience.

Manisha [00:14:51] Sure. So just taking climate as an example and walking through the framework I've described in this conversation earlier, let's look at the three lenses I talked about earlier. From a values perspective, that could be clients that personally believe that they don't want to support high emitting sectors or that it's wrong to heat the planet. For that reason, they might want to divest or exclude certain companies in their portfolio. That's an example of a values-based approach. Now you can argue that there could be other reasons from a risk perspective to exclude certain companies, which then segways into the second approach, which is the value or the financial materiality lens, where climate risks and opportunities could impact businesses and their long-term ability to be competitive. This, again, is dependent on business models, sectors, the growth trajectory of companies. So, it's not a one size or one answer for all companies, but from an investor lens perspective, it does bring up the question of as we're evaluating investment opportunities, how are our underlying investments positioned for an energy transition? The third lens we talked about earlier is the impact lens or the intentional outcomes lens. In this case, investors could seek to intentionally invest in solutions that are positioned for a successful energy transition. And this could include climate adaptation mitigation or explicit carbon removal opportunities. So, you think about renewable energy or renewable energy infrastructure, green fuel, battery storage, other carbon removal or carbon capture technologies. All of these are increasingly offering investable opportunities to investors. So, while I've described all of these three approaches as separate, in practice, these are not mutually exclusive. And an investor may come to the table and think about where they're coming from, what their portfolio looks like and what is the most prudent way to incorporate these approaches in line with their focus on climate.

Ben [00:17:18] And following up to that, I know investors often get concerned about potentially giving up returns as they pursue responsible investing. You kind of alluded to that, but can you elaborate on that for the audience?

Manisha [00:17:29] Ben, I would be remiss in making any claims about expected return for any strategy. Having said that, I would say the devil is in the details and it goes back to the intended objectives and method of implementation of any solution an investor is looking at. So, if we go back to the concept of negative screening, where if an investor is seeking to exclude a portion of the market from their portfolio, then arguably they're giving up potential return from that part of the market. In the case of impact approaches, it depends on if the investments are structured to be market rate or concessionary. And finally, in the case of financial materiality or more broadly, ESG strategies, it'll depend on how financially material issues are being evaluated and the results being incorporated in the investment selection and portfolio construction process. And again, it's not a one size fits all answer.

Ben [00:18:33] So finally, Manisha, the labeling of certain vehicles can be quite confusing for investors. How should investors navigate their concerns around greenwashing?

Manisha [00:18:42] Right. So, in my view, there are two ways to think about greenwashing. One is the labelling aspect and the second is the process. I think what we're starting to see is regulators globally starting to establish rules and guardrails around what strategies in the responsible investing space should be called or labelled. If they have a certain label, what does that mean? The second aspect is around process. So regardless of what you call yourself, in line with the regulations existing or proposed, regardless of what you call yourself, are you doing what you're saying you're doing? In other words, does your process align with or is it consistent with what you're saying, whether it's your solution name or strategy name or your strategy's objective.

So, there’s two lens to look at it. While regulation is targeting the nomenclature and the labelling, I think a key part that investment fiduciaries and investment advisers like ourselves play is drilling down to evaluate the integrity of the process. For example, when we at BNY Mellon are evaluating investment solutions for our clients who are interested in responsible investing, we look at things like, who is doing the ESG research when we're looking at a manager. Is it being done separately from the traditional financial analysis or part of it? What are the data sources that are being utilized? Is there reliance on third-party data? Or are the managers conducting their own due diligence as part of the process? And then, do they engage with investee companies? Finally, it's also important to look at what reporting and metrics managers are providing as validation of the approach. There's much more, but hopefully, this gives you a flavor of what in our view is important to understand, is a manager or is a strategy truly integrating or incorporating ESG or sustainability issues consistent with what they're saying that they're doing? Looking forward, while I expect to see regulation paving the path to higher levels of clarity and standards setting, it's important that investors lean on their investment consultants and advisors and see them as an ally to be diligent, to ask critical questions to ensure that they're getting what they want.

Ben [00:21:19] Thanks, Manisha. Those are wonderful insights and thank you for joining us on Earth Day to discuss Responsible Investing.

Manisha [00:21:25] Thank you, Ben. It's been a pleasure talking to you today.

Ben [00:21:28] At BNY Mellon Wealth Management, we have over 200 years of experience working with individuals to help craft comprehensive wealth strategies. To learn more about how BNY Mellon Wealth Management can help your Responsible Investing efforts, I encourage you to reach out to BNY Mellon Wealth Manager. I'm Ben McGloin, thanks for joining us and we'll see you on our next episode of *Your Active Wealth.*

VO [00:21:48] 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.