Faithful Investing: An Introduction to ESG
ESG 101

What is ESG?
ESG stands for Environmental, Social, and Governance. ESG Investing is a very broad term and can be implemented in a variety of ways by taking the consideration of environmental, social and governance factors alongside financial factors in the investment decision-making process. ESG investing has increased in popularity among asset managers in the past few years. There is growing evidence that ESG investing is moving from a niche corner of the asset management world to the mainstream. Traditional investors are increasingly considering and incorporating these ESG factors when making investment decisions.

What does ESG cover? The table below summarizes some of the issue areas under each of the three pillars. There is no single exhaustive list of ESG issues, in part because issues are often interconnected. As an example of this interconnection, climate change is an environmental issue but is highly inter-related with other risks, such as food and water security, social instability, and involuntary migration. Also, worth mentioning, the social factors (S) include factors such as product safety, labor policy, diversity, and human rights policies which are often related and thus are comparatively more difficult to measure independently of each other. At the beginning of ESG investing, investors were primarily focused on excluding bad actors that exhibited poor behavior. Over time, the concept has expanded towards also embracing good actors and giving credit for good behavior.

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Source: KoCAA and BA, CFA Institute, US SIF

Growing Investor Demand and Interest
The amount of interest and number of assets flowing into the ESG space have grown steadily in recent years. However, the growth of ESG is not self-generated, but is in response to investors, corporations, public policymakers, regulators, and non-profit organizations seeking more identification of these behavior comparisons across companies.

ESG Disclosures Demand for the disclosure of ESG information is on the rise. As far back as 2014, according to a PriceWaterhouseCooper survey titled “Sustainability Goes Mainstream”, 82% of global institutional investors had considered sustainability information in their investment decisions in the last 12 months. In the subsequent years, a growing number of countries have passed legislation or requested that companies increase the reporting on sustainability information. They have additionally sought to
formalize ESG reporting standards, which has resultinglly increased the demand for disclosure of ESG information.

According to the Governance & Accountability Institute, Inc (G&A’s) annual research illustrated in the chart below, only about 20% of S&P 500 companies were publishing sustainability reports in 2011. Reporting increased significantly over the next two years to 72% by 2013, with their most recently updated data reflecting 2019 results reporting that 90% of the S&P 500 were publishing sustainability reports. This represents an approximate 350% increase in reporting over the past ten years.

Performance Misperception One of the common critiques of ESG investing is that it results in lower returns. Increasing amounts of data, however, suggest that incorporating ESG into investment analysis and portfolio construction may offer investors the potential for long-term competitive returns and risk reduction. Pursuing ESG or “doing good” may not necessarily come at the cost of investment returns (i.e., “doing well”). According to a Morningstar article on U.S. Sustainable Funds1 “Sustainable funds comfortably outperformed their conventional peers in 2020, especially equity funds.” Of the sustainable equity funds ranked by Morningstar, 75% ranked in the top half of their Morningstar category, and 43% posted top quartile returns. The report also stated “By contrast, the returns of only 6% landed in their category’s bottom quartile.” While this is just a small window in time of the historical performance of ESG funds vs conventional funds, it provides a promising rebuttal to a common narrative that the performance and upside of ESG funds may be limited by perceived financial burdens of investing in more ESG friendly policies and practices.

Additional support comes from a newly released report from the NYU Stern Center for Sustainable Business, ESG and Financial Performance: Uncovering the Relationship by Aggregating 1,000 Plus Studies Published between 2015-2020, which concluded, “We found a positive relationship between ESG and financial performance. For investment studies typically focused on risk-adjusted attributes such as alpha or the Sharpe ratio [investment performance metrics] on a portfolio of stocks, 59% showed similar or better performance relative to conventional [non-ESG] investment approaches while only 14 percent found negative results.”

1 Morningstar Report: U.S. Sustainable Funds Continued to Break Records in 2020

2 ESG AND FINANCIAL PERFORMANCE:
https://www.stern.nyu.edu/sites/default/files/assets/documents/NYU-RAM_ESG-Paper_2021%20Rev_0.pdf
Evidence of a competitive return narrative is also supported over a longer-term basis according to a Financial Times report\(^3\) from June 2020, which is quoted below and determined that the majority of ESG funds outperformed the wider market over the most recent 10 years at the time of publishing.

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“Close to six out of 10 sustainable funds delivered higher returns than equivalent conventional funds over the past decade, according to a study that undermines claims that investing based on environmental, social and governance principles hampers performance.” -- Financial Times\(^3\)
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**Assets Under Management** Recent data indicates that there is a growing demand for ESG, with more incremental assets flowing into ESG or sustainable investing over the past decade. The chart below from US SIF shows that there was “$16.6 trillion in US-domiciled assets at the beginning of 2020 held by 530 institutional investors, 384 money managers and 1,204 community investment institutions that practice ‘ESG incorporation’—applying various environmental, social and governance (ESG) criteria in their investment analysis and portfolio selection.”

![US SIF sustainable and impact investing money managers 2020 chart](image)

Source: US SIF website

Also according to Morningstar\(^5\): “In 2020, sustainable funds were more attractive than ever for US fund investors. For the fifth calendar year in a row, sustainable funds set an annual record for net flows: Flows reached $51.1 billion, with $20.5 billion of that coming in the fourth quarter.” Based on Morgan Stanley’s research report: The total amount of assets in ESG ETFs now sits at $251 billion, vs just $61 billion at the end of 2019.

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\(^3\) Financial Times: https://www.ft.com/content/733ee6ff-446e-4f8b-86b2-19ef42da3824

\(^4\) Report on US Sustainable and Impact Investing Trends 2020

\(^5\) Morningstar: Sustainable Funds U.S. Landscape Report.
ESG Investing Strategies

Investment Methodologies
As ESG investment becomes more robust, asset managers have increasingly incorporated ESG issues into their investment processes in order to accommodate a growing investor demand for ESG considerations. ESG investing can be implemented in a variety of ways.

The chart below provides a summary of various ESG investment methodologies:

- **Negative/exclusionary screening**: Excluding investments or companies based on specific business activities, values, or Socially Responsible Investing (SRI).

- **Positive/best-in-class screening**: Seeking to invest in leaders within a sector for positive ESG performance relative to peers; excluding or avoiding companies that are laggards.

- **ESG integration**: The systematic incorporation of ESG considerations across all business activities and investments to target companies exhibiting both financial and non-financial sustainability to help enhance risk-adjusted returns. ESG integration is the analysis of all material factors that go into investment decisions.

- **Thematic investing**: The selection of assets specifically related to certain sustainability themes; currently trending themes include climate-focused, water-related, and gender lens investment strategies.
• **Impact investing**: Targeted investments aiming to solve social or environmental problems. For instance, UN SDG\(^6\) focused strategies or Green Bond investing are examples of impact investment focuses.

In addition to the broader ESG investment methodologies listed above, active ownership and influence over public policy development are other important ways that asset owners and managers are incorporating ESG.

Active ownership may include three specific methods:

- **Proxy Voting**: Shareholders are entitled to vote their shares in publicly traded companies. Proxy voting gives investors a voice and a say in the governance of companies in which they invest.

- **Shareholder Resolution**: Shareholders are entitled to propose shareholder resolutions to a publicly traded company's management and collect votes during the next annual meeting. Shareholder resolutions may pertain to company policies and procedures, corporate governance, or major social or environmental concerns. Shareholder resolutions are a powerful and effective way to encourage corporate responsibility and discourage inappropriate or unethical company practices.

- **Shareholder/Corporate Engagement**: Engagement is primarily about communication. Investor-company engagement helps build mutual understanding around investor expectations with boards and management, usually in relation to company governance and how various ESG criteria support financial sustainability.

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\(^6\) UN SDG: The Sustainable Development Goals (SDGs) or Global Goals are a collection of 17 interlinked global goals designed to be a "blueprint to achieve a better and more sustainable [https://en.wikipedia.org/wiki/Sustainability](https://en.wikipedia.org/wiki/Sustainability)" to "Sustainability" future for all".  
Data Providers and Stakeholders
In recent years, there has been a significant increase in the number of data providers and stakeholders within the ESG space. A wide range of constituencies—including shareholders, investors, corporations, policymakers, regulators, and NGOs (non-governmental organizations)—use corporate sustainability reporting to inform decisions. A dynamic yet complex ecosystem has been formed to meet these various information needs.

- **Guidance & Standards (SASB, IIRC\(^7\), TCFD):** Guidance and standard-setting organizations aim to provide frameworks, standards, and standard-setting processes. The goal is to create a comprehensive system to address the challenges that investors face, given that ESG reporting and metrics can be interpreted in many different ways.

- **Data Questionnaires (CDP, Dow Jones Sustainability indexes):** These entities send out questionnaires to collect proprietary data and information directly from corporations to increase the transparency of reporting.

- **Data Aggregators (Bloomberg, Refinitiv):** These companies pull various data from an ever-expanding number of data providers.

- **Rating Agencies (MSCI, Sustainalytics, Reprisk):** Ratings agencies give rankings on companies based on their ESG profiles and risk appetite.

![Sustainability Information and Analytics Landscape](image)

Source: SASB

Standards & Materiality
The arrival of ESG investing to the mainstream has resulted in an overwhelming number of data providers, all of whom collect, interpret, and distribute that data differently. This has created many challenges for investors, who are clamoring for a more comprehensive understanding of just which data is relevant and important.

As the industry matures, certain stakeholders have begun to emerge as likely leaders in the march towards standardized ESG data. Governmental regulatory agencies like the SEC are also chiming in.

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\(^7\) Please note: Sustainability Accounting Standards Board (SASB) and the International Integrated Reporting Council (IIRC) merged in June 2021. The new entity is called the Value Reporting Foundation.
According to CRISIL, a ratings and research provider, “a set of generally accepted principles for climate and other ESG reporting at the global level will likely emerge in the next few years.” This convergence will provide enhanced access to sustainability key performance indicators (KPI’s) that can be used both by companies to report ESG data and by investors seeking to understand their investments.

A key concept in the development of ESG investing is materiality. In an ESG context, materiality refers to “the relevance of a sustainability factor to a company’s financial performance.” Whether or not an ESG factor is financially material depends in large part on the sector and industry in which the company operates. For example, a bank’s recycling program may fall under the “E” of ESG, but will not have a material impact on the bank’s performance. Its anti-money laundering and data security practices, however (an “S” consideration), will have such an impact, and as such would be an important factor to consider when evaluating a potential investment. Any impact a factor has on cash flow or cost of financing is considered material.

The goal of standard-setting entities is to identify the financial materiality of ESG factors so that firms may be compared across sectors. The result of the development of both standards and materiality considerations is an investing ecosystem in which companies, investors, and various stakeholders all have access to the most important, relevant and material information as they make decisions within capital markets.

This focus on materiality has played a crucial role in bringing ESG to the mainstream, as investors become increasingly aware that ESG factors can play a significant role in either value creation or destruction for any particular company. Focusing on materiality when using ESG in the investment process means that the investor is staying focused on what matters most for any particular company. Not all ESG issues matter equally; evidence presented by Khan, Serafeim and Yoon (2016) suggests that “investment in sustainability issues leads to financial outperformance, but only when the investment is in sustainability issues that are financially material to the firm.”

**Responsible Investing at KoCAA**

**Responsible Investing Philosophy**
While KoCAA has long practiced exclusionary Catholic screening in its investment strategies, the inclusion of ESG considerations in the investment process has grown over the past couple of years. Our Responsible Investing Steering Committee (RISC) was created to ensure that we continue our tradition of excellence in serving the investment needs of our clients.

We believe that understanding ESG risks helps provide deeper insight into portfolio companies. The identification and analysis of financially material factors may help mitigate risk over the long term, potentially enhancing portfolio returns. ESG analysis can contribute to a more holistic understanding of a company, which is consistent with one of the critical objectives of our hybrid investment approach. Put simply, we believe incorporating ESG considerations within our analysis puts us in a better position to make better investments.

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For our Catholic screened assets, our investment process is purposefully aligned with the USCCB Socially Responsible Investment Guidelines published in 2003\(^{11}\). The guidelines outline three approaches that asset owners may take when investing through a Catholic lens.

1. **Do no harm (avoid evil):** This means no investment in companies whose products or policies are counter to values expressed in Catholic moral teaching; e.g. no abortion, birth control, pornography, stem cell research, racial or sexual discrimination, or certain military weapons. We use a screening service from an industry-leading data provider, which consistently monitors the investable universe using a screen based on USCCB guidelines, to ensure that we do not make any investments in prohibited categories.

2. **Active corporate participation:** We vote proxies in keeping with USCCB guidelines and are exploring other ways in which we might participate in active engagement.

3. **Promote the common good:** As we continue to integrate more ESG considerations into our investment process, we seek to be increasingly able to evaluate our portfolio companies for the ways in which they promote the common good in alignment with USCCB guidelines. For example, the promotion of human dignity may occur by investing in companies that do not use child labor in their supply chains; or by choosing companies with a history of promoting racial equality.

**ESG & Responsible Investing Processes**

We believe our responsible investing philosophy has helped inform our investment process, and ESG is a consideration for analysts and portfolio managers within their qualitative analysis of a company. If a name is under consideration for inclusion in the portfolio, it not only must pass the exclusionary screen, but will also be evaluated for available sector-specific material ESG factors as part of the investment due diligence process. For example, a mining company’s environmental practices regarding water management and employee safety may be considered additionally material alongside its earnings potential, free cash flow, and leverage.\(^{12}\) A technology company would be evaluated for its growth potential, but its cybersecurity history and its management of human capital may also impact its inclusion into the final portfolio.\(^{13}\)

In addition to reviewing companies for a variety of material ESG factors, the investment teams monitor controversies, headlines or financial risks that might develop for any particular company. We pay close attention to news stories and reports that focus on key material ESG factors and evaluate whether or not those developments may have a potentially adverse impact on performance or portfolio risk levels. The incorporation of ESG considerations into our investment process has added depth and enhanced the knowledge of our portfolio companies.

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\(^{11}\) USCCB Socially Responsible Investment Guidelines: [https://www.usccb.org/about/financial-reporting/socially-responsible-investment-guidelines](https://www.usccb.org/about/financial-reporting/socially-responsible-investment-guidelines)

\(^{12}\) Modern Catholic Social Teaching has increasingly emphasized care for the environment as a moral responsibility and has devoted a growing amount of attention to it. Pope St. Paul VI warned of the human ability to destroy the environment through pollution (*Octegesima adveniens*, no. 21). Pope St. John Paul II warned of approaching the natural world through the lens of consumption and becoming an “exploiter” and “destroyer” of it (*Redemptor hominis*, no. 15) rather than treating it as a form of stewardship sharing in the work of God the Creator (*Laborem exercens*, no. 25). Human dominion must use resources judiciously and sustainably (cf. *Solicitudo rei socialis*, no. 34). Benedict XVI linked “integral human development” with an “ecology of man” in *Caritas in veritate* (nos. 48-49). Pope Francis has devoted an entire document to “care for our common home” and links “integral ecology” with the connectedness of all things in creation (see *Laudato si’,* no. 70) and with “intergenerational solidarity” (*LS*, no. 159). This growing body of teaching makes it clear that ESG concerns overlap in significant ways with Catholic Social Teaching.

\(^{13}\) This is in keeping with the focus on respect for the dignity of person found in the USCCB Guidelines and in Catholic Social Teaching more generally.
The Future of ESG Investing at KoCAA

The sustainable investing space is growing more rapidly than at any point in its history. At Knights of Columbus Asset Advisors, we are committed to staying on top of current and future trends so that we may continue to serve our clients in the best way possible. Our responsible investing strategy and development plan includes training for investment teams; periodic evaluation of data partners and providers; and, more than anything, a deep commitment to investing in a way that allows our clients to invest with the confidence that they are doing so in alignment with their Catholic values.

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Ms. Burlock joined the firm in 2014, and worked closely with Operations, Marketing and Compliance teams before joining the investment team. She earned a B.A. in Portuguese & Brazilian Studies and English Language & Literature from Smith College and a Masters of Divinity from Boston University School of Theology. Ms. Burlock is a Level II CFA Candidate and a member of the CFA Institute and CFA Society Boston.