The Truth on ESG

REGIONS ASSET MANAGEMENT

July 2021

ESG investing is a form of sustainable investing that also focuses on an investment's financial returns. ESG covers Environmental, Social, and Governance concerns. Companies may focus on one or all of these criteria. Environmental criteria issues consist of carbon emissions, climate change, pollution, and conservation efforts. Social criteria include labor practices, health and safety, supply chain relationships, harmful products or services, community impact, and data privacy. Governance criteria include company leadership, executive pay, audits, internal controls, shareholder rights, disclosures, conflicts of interest, political contributions, and fraud. Companies that are taking proactive steps in these areas to benefit society would therefore be considered for investment.

Responsible Investing Types:

There are other forms of investing similar to ESG that have been used for decades. One very common type is Socially Responsible Investing, or SRI for short. This method goes a step further than ESG by excluding investments from a portfolio and selecting ones that follow specific ethical guidelines. Such ethical guidelines vary by investor and could have an underlying bias based on their personal values, religion, or political opinions. This results in profit not being as important compared to ESG and will be different based on individual investors views rather than a common factor used in ESG portfolios. SRI's overall goal is to generate returns, but without violating one's social conscience.

There is also the term Impact Investing that ensures investments have a positive impact in some way. Impact Investing's goal is to help businesses and organizations accomplish goals that are also benefitting the environment or society. The overall strategy is to use investment capital for positive social outcomes. These funds report on financial performance and attempt to generate a quantifiable positive social impact such as reduction of carbon footprint by a certain number of units or by the number of schools that have been built in under privilege areas. Impact investors are often able to invest in funds whose cause is not directly related to the public financial markets such as community development and helping those in poverty.

Why is it Important?

Many studies show that a growing number of investors are looking to invest in companies which have a positive impact on society or the environment. As online investing platforms are becoming more accessible to the public, the average age of investors is decreasing. As younger investors are participating in investing, they are more inclined to invest in ESG companies. About one-third of millennials have some investments or are exclusively invested in securities that take ESG factors into account, compared to only 2% of the baby boomer population.[i] Considering ESG factors are becoming more important to investors it is expected to be a continually growing space. In 2020 funds that used ESG principals doubled their growth of net new money invested by $50.1 billion. In the same year ESG funds also made up about a quarter of the money in all US stock and bond mutual funds.[ii]

Most financial firms have pledged in some way to integrate ESG into their portfolios. This is becoming more accessible as most companies are looking to be more environmentally friendly and focused on increasing the diversity of their employees and board of directors. For the environmental side this is evident by car manufacturers for example creating electric vehicles and pledging to go completely electric in future decades. Even Fed-Ex and the United States Postal Service have committed to investing in fuel-efficient and electric vehicles. Many companies are also making plans to recruit a more diverse workforce. Companies that are progressing towards goals such as these can then be options to implement into an ESG portfolio.

There are other countries that have taken even greater initiatives towards ESG investing compared to the United States. In some countries there are regulations that require companies to follow ESG criteria and create an ESG report at the end of the year and post it publicly for investors. By the end of 2020 New Zealand, Norway, Singapore, Sweden, and Iceland had the highest environmental, social, and governance scores. Given this past year these scores included aspects of how a country responded to Covid-19. The scores also incorporated the impact of disease, government intervention, and vulnerability to the country's population.[iii] For reasons

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like these it results in being a more popular investment option overseas than in the United States. Europe for example has taken approaches towards ESG investing years before it became as popular in the US, resulting in Europe accounting for almost 70% of global ESG mutual fund assets as of December 2020. The ESG gap between Europe and the United States exists in fixed income as well. In December of 2020 European green bond issuers raised almost $100 billion more compared to the US.[iv]

ESG Returns:

One common concern by investors is that ESG may have a good impact on society, but it may not be good for portfolio performance. However, multiple valuations of a variety of funds have been conducted to prove that ESG funds have similar returns to the S&P 500 index. From 2,200 individual research studies on ESG, it was found that 90% of such studies resulted in a non-negative relationship to Corporate Financial Performance.[v] Majority of the studies even reported in a positive performance resulting in more profit.

During the Covid-19 pandemic ESG funds outperformed the market, thus providing more evidence environmental, social, and governance related funds tend to do best in turbulent markets. The S&P 500 Global Market Intelligence analyzed 26 ESG exchange-traded funds and mutual funds with over $250 million in assets under management from March 5, 2020 to March 5, 2021 and found that 19 of those funds outperformed the S&P 500 index. These funds rose between 27.3% to 55% in that one-year period compared to the S&P 500's increase of 27.1%.

In fact, Morgan Stanley conducted research to compare the performance of sustainable funds to traditional funds from 2004 to 2018 and found that they were in line with each other. During this time period there were bear markets, especially the Great Recession, that were tested to find the difference between funds in many turbulent market times. These funds had some sporadic and inconsistent differences but were not statistically significant. This study even showed that sustainable investing funds are less risky than traditional funds.

ESG Risks:

Although ESG investing may have many benefits, there are still some risks that come along with this form of investing. For example, there are not universal ESG standards for evaluating ESG performance. Because ESG criteria can vary depending on what each individual investor wants in their portfolio this creates inconsistencies in ESG portfolios. Since criteria varies by what aspects you want to focus on, you must research different funds that align with your areas of interest. On top of this, companies are not required to report their ESG data and could voluntarily stop reporting. Another risk is that there is no long-term data on ESG companies' financial performance. ESG companies are still relatively new so there will not be as many financial reports to pull from to predict their future performance as accurately.

Conclusion:

ESG investing is becoming more popular with investors. It is a growing area of investing all around the world. As time goes on ESG criteria is increasing its importance for individuals and companies. It can provide similar return opportunities as traditional investing, and in the end should benefit society overall. Given the benefits while not sacrificing performance it is relatively safe to say ESG investing is here to stay. Please contact a member of the Regions Wealth Management team for additional information about Regions ESG philosophy and how Regions Asset Management can tailor an ESG portfolio to meet your specific ESG desires.

[i] *Adamczyk, Alicia. "Millennials Spurred Growth in Sustainable Investing for Years. Now, All Generations Are Interested in ESG Options." CNBC, CNBC, 21 May 2021, www.cnbc.com/2021/05/21/millennials-spurred-growth-in-esg-investing-now-all-ages-are-on-board.html.*

[ii] *Iacurci, Greg. "Money Invested in ESG Funds More than Doubles in a Year." CNBC, CNBC, 11 Feb. 2021, www.cnbc.com/2021/02/11/sustainable-investment-funds-more-than-doubled-in-2020-.html.*

[iii] *Norton, Leslie P. Where the U.S. Ranked on ESG in 2020, Barrons, 2 Feb. 2021, www.barrons.com/articles/new-zealand-singapore-and-sweden-have-highest-esg-scores-sustainalytics-says-see-where-the-u-s-ranked-51612226205.*

[iv] *Marsh, Alastair. "U.S. Falls Further Behind Europe in Fast-Growing ESG Market." Bloomberg.com, Bloomberg, 20 Dec. 2020, www.bloomberg.com/news/articles/2020-12-21/u-s-falls-further-behind-europe-in-fast-growing-esg-market.*

[v] *Rotonti, John, and Alyce Lomax. "Does ESG Investing Produce Better Stock Returns?" The Motley Fool, The Motley Fool, 22 May 2019, www.fool.com/investing/2019/05/22/does-esg-investing-produce-better-stock-returns.aspx.*

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