Funds' Use of ESG Integration and Sustainable Investing Strategies: An Introduction

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The Investment Company Institute (ICI) is the leading association representing regulated funds globally, including mutual funds, exchange-traded funds (ETFs), closed-end funds, and unit investment trusts (UITs) in the United States, and similar funds offered to investors in jurisdictions worldwide. ICI seeks to encourage adherence to high ethical standards, promote public understanding, and otherwise advance the interests of funds, their shareholders, directors, and advisers. ICI carries out its international work through ICI Global, with offices in London, Hong Kong, and Washington, DC.

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Background

Investors worldwide are increasingly interested in environmental, social, and governance (ESG) matters. ESG matters vary widely but generally are considered to mean:

» Environmental or "E" matters, such as climate change, resource depletion, waste, pollution, or deforestation;
» Social or "S" matters, such as companies' relationships with their employees and suppliers, including labor standards, diversity, and human rights issues; and
» Governance or "G" matters, such as shareholder rights, bribery and corruption, executive pay, and board composition.[1]

Managers of registered investment companies (funds) are responding to investor demand by creating funds intended to align with investors' values and, in some cases, achieve sustainability-related outcomes. Fund managers also seek to provide risk-adjusted financial return, or value, to investors by integrating material ESG information into their investment process. In addition, virtually all fund managers engage with their portfolio companies, an activity referred to as stewardship. Stewardship typically is conducted across all portfolios, both active and index, and includes voting proxies and engaging in dialogue with company management.

Funds engage in stewardship activities for a variety of reasons, including to:

» protect and enhance the value of a fund's portfolio holdings;
» address material risks to a fund's portfolio holdings;
» advance ESG-related practices that may affect the sustainability of a company's long-term profits; and
» help companies to innovate and operate more efficiently to enhance their long-term financial performance.[2]

ICI's ESG Working Group

The Investment Company Institute created a working group of senior executives from ICI member firms[3] to review comprehensively how funds describe ESG integration and sustainable investing strategies. ICI's ESG Working Group found that funds were describing similar investing concepts in a variety of ways. To promote the understanding of investors, other market participants, regulators, and others, the working group agreed that it would be good practice for funds to use consistent terminology to describe ESG strategies in their public communications.[4] This publication sets forth the working group's understanding of the range of those strategies and explains how a fund investor might differentiate among them. It does so by generally discussing the differences between integration and the three common sustainable investing strategies. It then further explains the variations among each of these investment strategies, followed by examples from fund websites and prospectuses that describe how specific funds choose their investments.

1 For simplicity, this publication will use the term *ESG* rather than differentiating between E, S, and G strategies. Funds, however, may focus on any one or more of these matters. Also for simplicity, this publication refers to *funds* and *fund managers* interchangeably.

2 Stewardship is distinct from the investment strategies discussed in the remainder of the document.

3 See Appendix A for a list of working group member firms.

4 Communications include regulatory documents such as summary prospectuses and shareholder reports, and other voluntary disclosures, including advertisements, sales literature, and websites.

Board of Governors Endorsement

This publication received ICI's Board of Governors' unanimous endorsement. The Board of Governors strongly endorsed the recommendations of the working group and urged all ICI members to take actions as may be appropriate to implement the terminology recommended as soon as reasonably practicable.

Broad Spectrum of ESG-Related Investing Strategies

Fund managers consider ESG factors to varying degrees, and these approaches coexist on a broad investing spectrum. For decades, some fund managers have integrated, or incorporated, ESG factors into their investment processes to the extent that those factors are financially material. Fund managers seek to enhance performance, manage investment risks, and identify emerging investment risks and opportunities, much as they would consider macroeconomic or interest rate risks, idiosyncratic business risks, and investment exposures to particular companies, industries, or geographical regions. Sustainable investing is a strategy that uses ESG analysis as a significant part of the fund's investment thesis to respond to investors' objectives, accomplish ESG-related outcomes, and pursue investment returns.

Not every fund manager incorporates ESG factors in the same manner; in fact, there are a range of qualitative and quantitative approaches for embedding ESG analysis across investing strategies, spanning asset classes and active-to-passive strategies. As Figure 1 illustrates, ESG-related investing strategies exist along a continuum.

FIGURE 1

ESG Investing Exists Along a Continuum

Note: Each of these investing strategies may also incorporate aspects of exclusionary investing.

As Figures 2 and 3 below illustrate, funds employ integration and sustainable investing strategies in various ways. Some funds integrate analysis of ESG factors, others use one or more sustainable investing strategies, and some integrate ESG factors and use one or more sustainable investing strategies.

FIGURE 2

Relationship Between Integration and Sustainable Investing Strategies

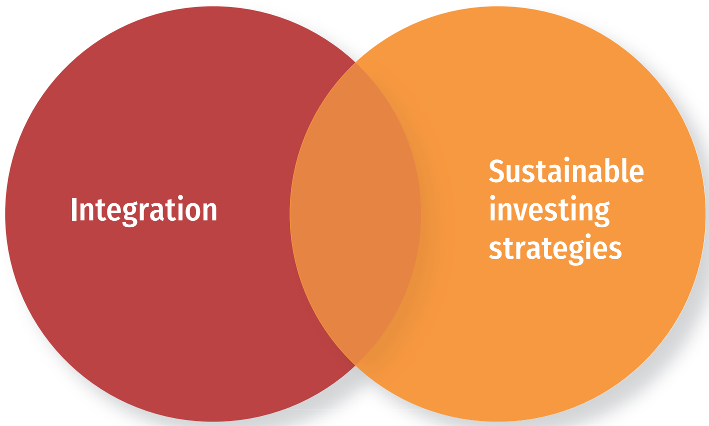
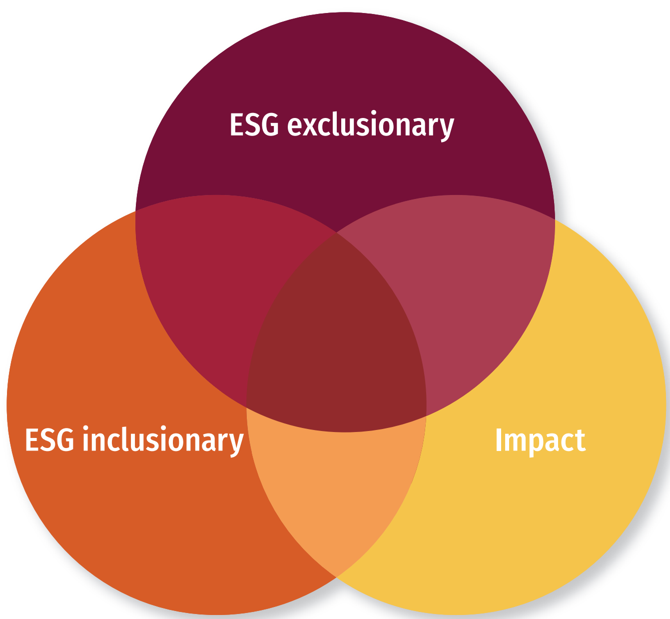


FIGURE 3

Funds May Incorporate Sustainable Investing Strategies in Multiple Ways



This publication first describes ESG integration and then illustrates three common sustainable investing strategies, with examples of each.

Integration and Sustainable Investing Strategies Explained

ESG integration and sustainable investing are both investment processes that coexist along a spectrum. One way to distinguish them is to recognize that funds integrate ESG factors into their traditional investment process as a way to seek financial returns. Funds that have a sustainable investment objective use ESG analysis as a significant part of the fund's investment thesis to meet investors' objectives while seeking financial returns.

Integration

Fund managers may incorporate, or integrate, ESG considerations into their investment process along with other material factors and analysis. Funds typically explain how they do so on their websites. This long-standing element of investing seeks to enhance a fund's financial performance by analyzing material ESG considerations along with other material risks such as credit risk and counterparty risk.

This publication provides several examples of how different fund managers describe integration, ESG exclusionary investing, ESG inclusionary investing, and impact investing.[5]

Example 1

The fund manager considers ESG integration as taking into account financially material ESG factors as components of the investment process in order to seek to enhance risk-adjusted return. The fund manager believes investment decisions are better informed by considering these factors alongside more traditional financial, industry-related, macroeconomic, and other qualitative indicators. As ESG integration is an enhancement to achieving a financial goal, we believe it can be applied across a wide spectrum of portfolios.

Example 2

The fund manager does not separate ESG issues from the rigorous analysis conducted for each and every investment, which seeks to generate risk-adjusted return. ESG analysis is integrated into each of the stages of the investment process. Fundamental research is critical for a full understanding of the risks and opportunities that ESG factors present, especially considering that many companies' public disclosure continues to be inconsistent.

Example 3

The fund manager incorporates ESG issues into investment analysis and decisionmaking processes for the fund. The fund manager follows an investment approach of implementing ESG research by making ESG performance ratings and research available to portfolio managers and analysts in our investment tools. In developing an understanding of a portfolio company, the fund manager may take into account its approach to managing ESG issues for the purpose of enhancing the fund's risk-adjusted returns.

[5] These examples originated from fund regulatory disclosures and websites.

Sustainable Investing Strategies

Sustainable investing strategies are distinct from ESG integration in that they use ESG analysis as a significant part of the fund's investment thesis to respond to investors' objectives and accomplish sustainability-related outcomes while seeking financial returns.

Funds commonly engage in sustainable investing using three nonexclusive investment approaches:

- ESG exclusionary investing
- ESG inclusionary investing
- Impact investing

ESG Exclusionary Investing

Funds with this type of investment approach may exclude companies or sectors that do not meet certain sustainability criteria or do not align with investors' objectives. They may use optimization techniques or diversification guardrails to limit large deviations from market performance.

Other terms include "negative screening," "optimization," "socially responsible investing (SRI)," and "values driven."

Example 4: ESG Equity Fund

Fund A invests in the equity securities of US companies meeting the fund's social criteria. To determine which companies meet the fund's social criteria, the fund's manager incorporates into its investment process industry classifications and research services from an independent social research service. The fund does not invest in companies that have significant business related to weapons manufacturing or distribution, gambling, tobacco, alcohol, or nuclear energy. The fund also does not invest in companies that have a history of poor labor-management relations; engage in businesses or have products that have a severely negative impact on the environment or public health; have significant business operations in countries whose governments pose human rights concerns; or have a history of poor business ethics, which may include companies that have incidents of bribery or fraud, or poor governance structures.

Example 5: ESG Index Equity Fund

Fund B employs an indexing investment approach designed to track the performance of Index Z. The index, which is weighted by market capitalization, is composed of large-, mid-, and small-cap stocks of companies located in the United States that are screened for certain ESG criteria. Index Z excludes stocks of companies that the index sponsor determines engage in the following activities: produce adult entertainment; produce alcoholic beverages; produce tobacco products; produce nuclear weapon systems, chemical or biological weapons, cluster munitions, or antipersonnel mines; produce other weapons for military use; produce firearms or ammunition for nonmilitary use; own proved or probable reserves in coal, oil, or gas; or provide gambling services.

Example 6: ESG Equity Income Fund

Fund C's objective is to achieve both capital appreciation and current income by investing primarily in a diversified portfolio of equity securities. The fund is primarily a large-cap fund, which means that it normally invests more than half of its net assets in large, well-established companies. The fund may invest to a lesser extent in small- and mid-cap companies. To align with shareholders' objectives, the fund is fossil fuel–free, as it does not invest in companies that derive significant revenues from the extraction, exploration, production, or refining of fossil fuels; the fund may invest in companies that use fossil fuel–based energy to power their operations or for other purposes. Using a value-oriented investment process, the fund seeks to invest in equity securities that pay dividends, that have the potential for capital appreciation, and that the fund manager believes have the capacity to raise dividends in the future. To determine a company's prospects, the fund manager reviews the company's income statement, cash flow statement, and balance sheet, and analyzes the company's sustainable strategic advantage and management team.

ESG Inclusionary Investing

Funds with this type of investment approach generally seek positive sustainability-related outcomes by pursuing an investing thesis focusing on portfolios that fundamentally or systematically tilt a portfolio based on ESG factors alongside financial return.

Other terms include "best in class," "ESG tilted," "positive tilt," "positive screening," "sustainable," and "thematic."

Example 7: Clean Energy–Themed Equity Fund

Fund D invests in equity securities of companies that contribute to and benefit from clean energy generation, sustainable infrastructure and resources, transmission and distribution of clean energy, waste management, carbon reducing technologies and equipment, energy efficiency services and technologies, electrification of transportation, mobility and related services, sustainable agriculture and food production, water supply and management systems, and any related enabling technologies and materials.

Example 8: Global Sustainable Bond Fund

Fund E invests in bonds of issuers from around the world, including the United States, that meet the fund manager's sustainability criteria at the time of investment. In addition to considering financial information, the security selection process evaluates an issuer based on ESG criteria. An issuer's performance across certain ESG criteria is summarized in a proprietary ESG rating on the basis of data obtained from various ESG data providers. Primarily issuers with an ESG rating above a minimum threshold determined by the fund manager are considered for investment by the fund. The proprietary ESG rating for each issuer is derived from multiple factors, including exposure to controversial sectors and weapons; adherence to certain corporate governance principles; ESG performance relative to a peer group of issuers; and efforts to meet the United Nations' Sustainable Development Goals.

Example 9: ESG Select Stock Fund

Fund F invests in common stocks of companies that meet the fund manager's ESG criteria. The fund will typically invest in stocks of large and midsize companies located in countries throughout the world, including issuers located in emerging markets. The fund's investment approach is based on proprietary, bottom-up fundamental research conducted by the fund manager. The fund manager considers the investment universe, sector by sector and region by region, looking for companies with strong long-term fundamentals with an emphasis on the following company attributes: a proven track record of effective capital allocation; leading ESG practices (e.g., increased transparency into the company's ESG practices, board diversity, management teams with aligned incentives, better governance practices, and realistic assessment of long-term ESG risks and opportunities); and confidence that a wide gap between return on capital and cost of capital can be sustained. The fund manager will then examine issues outside the scope of traditional research—such as corporate culture, adaptability, and employee engagement—to build conviction in each holding.

Impact Investing

Funds with this type of investment approach seek to generate positive, measurable, reportable social and environmental impact alongside a financial return. Measurement, management, and reporting of impact is a defining feature of impact investing.

Other terms include "community investing," "goal-based," "sustainable," or "thematic."

Example 10: Municipal Income Impact Fund

Fund G invests the majority of its assets in securities whose use of proceeds, in the fund manager's opinion, provide measurable positive social or environmental benefits. In order to identify and invest in bonds that provide positive social or environmental benefits, the fund manager determines and assesses each bond's intended use of proceeds. The fund manager will generally view bonds that finance affordable housing, healthcare, municipal water and sewer, education, mass transit, not-for-profit organizations, and issuer designated "green bonds" as promoting positive social or environmental benefits.

Example 11: Green Bond Impact Fund

Fund H invests in "green bonds," which are bonds and notes where all of the proceeds are used to finance projects that the fund manager believes will have a positive environmental impact. Green bonds are usually issued to finance specific projects intended to generate an environmental benefit while offering potential market return in the same manner as other "conventional" fixed-income securities. Beyond fundamental security analysis, the fund manager independently analyzes each green bond's use of proceeds, degree of environmental impact, and general practices of the issuer.

Example 12: Equity Impact Fund

Fund I invests in an actively managed portfolio of 25 to 50 global high-quality growth companies that can deliver positive change in one of four areas: social inclusion and education, environment and resource needs, healthcare and quality of life, and base of the pyramid (addressing the needs of the world's poorest populations). The fund manager analyzes all holdings, looking at both the financial and positive impact aspects for each stock using a consistent framework.

This fund is suitable for all investors seeking a fund that aims to provide capital growth over a long-term investment horizon with a focus on delivering positive change by investing in companies addressing critical challenges in areas including, but not limited to, education, social inclusion, healthcare, and the environment.

Funds Using Multiple Sustainable Investing Approaches

Some funds pursue investment approaches that combine one or more elements of exclusionary, inclusionary, or impact investing, as described in the examples below.

Example 13: Equity Sustainable Fund (Inclusionary, Exclusionary)

Fund J invests primarily in common stocks of mid- to large-cap companies that meet the fund's quality-oriented financial and sustainability-related criteria. The fund invests in equity securities selected in accordance with its sustainability-related criteria. The fund manager employs a research driven and valuation sensitive approach to stock selection, with a focus on long-term sustainability. This sustainable investment approach seeks to identify high-quality, well-positioned companies with leadership that is focused on ESG criteria as defined by best in class operating practices. The fund also endeavors to avoid companies that derive revenue from gambling or the production of alcohol, tobacco, weapons, or nuclear power.

Example 14: Equity Fund (Inclusionary, Impact)

Fund K invests in an actively managed portfolio of 30 to 40 small- and mid-cap companies employing in-depth analysis of financially material ESG risks and opportunities as part of its broader review of the material and relevant risks to an investment. The fund manager uses its position as a significant shareholder (including proxy voting authority) to drive improvement on ESG performance resulting in measurable positive social impact. For example, it can point to more than 40 instances where it successfully encouraged portfolio companies to add underrepresented minority directors to their boards.

Example 15: Bond Fund (Inclusionary, Impact, Exclusionary)

Fund L invests in fixed-income securities that are subject to either ESG or impact criteria. The ESG evaluation process favors issuers with leadership in ESG performance relative to their peers. The ESG criteria are generally implemented based on data provided by independent research vendor(s). In those limited cases where independent ESG criteria are not available for certain types of securities or for certain issuers, these securities may nonetheless be eligible for the fund if they meet certain internal ESG criteria.

The impact criteria are established in a proprietary framework used to categorize bonds with use of proceeds that have a direct and measurable impact on four specific themes: affordable housing, community and economic development, renewable energy and climate change, and natural resources. The fund provides an annual impact report containing tangible results achieved against the objectives in each theme.

The fund will not generally invest in companies significantly involved in certain business activities including, but not limited to, the production of alcohol, tobacco, military weapons, firearms, nuclear power, thermal coal, and gambling products and services.

Example 16: ESG Fixed-Income Index Fund (Inclusionary, Exclusionary)

Fund M seeks to track the investment results of the ESG Fixed-Income Index. The index is an optimized fixed-income index designed to reflect the performance of US dollar–denominated, investment grade bonds from issuers generally evaluated for favorable ESG practices. The index excludes securities of entities involved in the business of tobacco, entities involved with controversial weapons, producers and retailers of civilian firearms, and entities involved in very severe business controversies.

The Investment Company Institute will continue to follow developments related to ESG investing. We hope that this publication will improve understanding of this dynamic and growing area of fund investing, and help inform investors and other market participants who are interested in ESG investing about the many choices funds provide.

Appendix A: ESG Working Group Member Firms

As of July 1, 2020

- Ariel Investments, LLC
- BlackRock, Inc.
- Capital Research and Management Company
- Columbia Threadneedle Investments
- Dimensional Fund Advisors
- Eaton Vance Corp.
- Fidelity Investments
- J.P. Morgan Asset Management
- Karla Rabusch, independent board member, Lord Abbett Funds
- Neuberger Berman
- New York Life Investment Management LLC
- Nuveen
- T. Rowe Price
- Vanguard
- Voya Investment Management

Appendix B: Additional Resources*

"Environmental, Social, and Governance Investing" in *2020 Investment Company Fact Book: A Review of Trends and Activities in the Investment Company Industry*, Investment Company Institute

» www.ici.org/pdf/2020_factbook.pdf at page 50

The Case for Simplifying Sustainable Investment Terminology, Institute of International Finance

» www.iif.com/Press/View/ID/3637/IIF-Proposes-Alignment-Around-Fewer-Simpler-Sustainable-Investment-Terms-to-Enhance-Transparency-and-Bolster-Confidence-in-the-Integrity-of-the-Market

Operating Principles for Impact Management, International Finance Corporation

» www.ifc.org/wps/wcm/connect/topics_ext_content/ifc_external_corporate_site/development+impact/principles/opim

Morningstar Sustainable Investing Handbook, Morningstar

» www.morningstar.com/content/dam/marketing/shared/Company/Trends/Sustainability/Detail/Documents/Morningstar-Sustainable-Investing-Handbook.pdf

Principles for Responsible Investing, United Nations

» www.unpri.org

Responsible Investing Framework Final Report, The Investment Association

» www.theia.org/sites/default/files/2019-11/20191118-iaresponsibleinvestmentframework.pdf

What Is Impact Investing? Global Impact Investing Network

» https://thegiin.org/impact-investing/need-to-know/#what-is-impact-investing

*ESG Working Group members identified additional resources for readers that wish to learn more about ESG-related investing. ICI is not responsible for the accuracy, completeness, or timeliness of third-party sources. Opinions expressed by third-party sources are not necessarily those of the Institute. If you have questions or comments about this material, please contact the source directly.

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