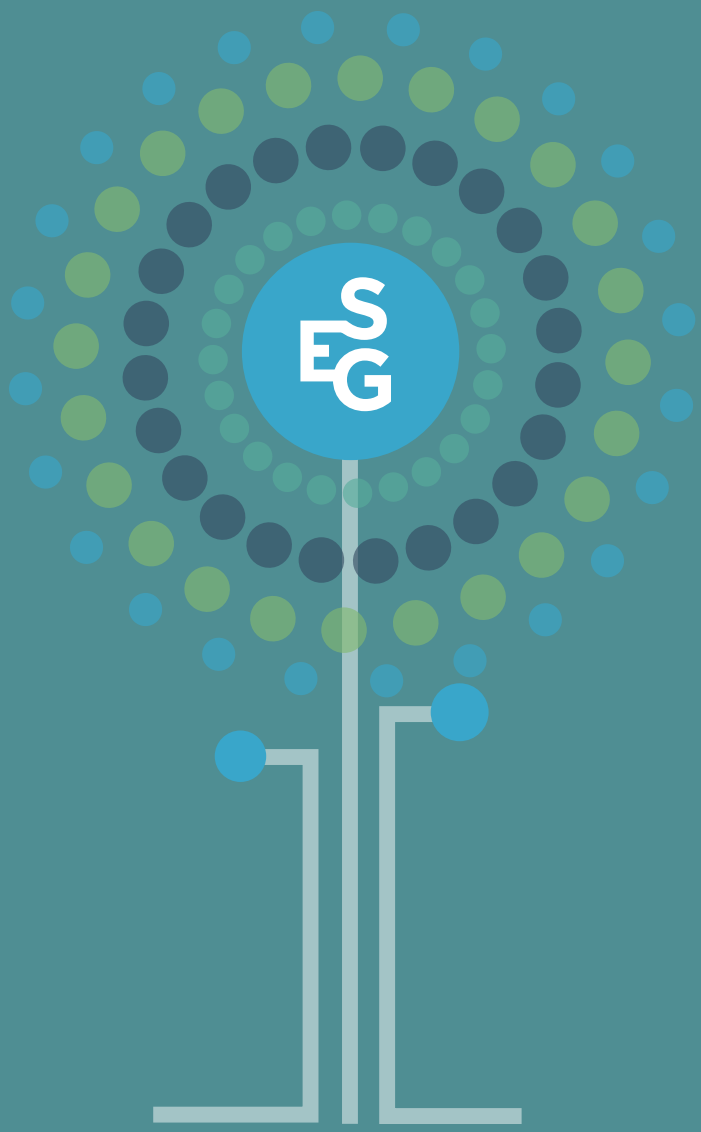
INTERSECT
Capital Management

ESG: Tomorrow's Investing Framework



INTELLIGENT ESG: An educational series from Intersect Capital Management

What is ESG?

THE FUTURE

Innovative

Financially irrelevant

Complex

Inefficient

MISUNDERSTOOD

Charity

Opportunity

Critically important

A judgment

Values

Tree Hugging

Mandate

Modern ESG investing, as we know it today, is the result of many decades of evolution. It has come a long way from where it all started back in the 1970s, with definitions and practices changing dramatically along the way.

So investors aren't wrong to be somewhat confused, given the different names used in different eras, and multiple overlapping terms like "sustainable," "socially responsible," and "impact." And the ESG space includes lots of different managers with lots of different philosophical approaches.

Our aim is to make the broad concept of "ESG" as simple and clear as possible.

In our view, applying ESG as an investor is quite straightforward:

"ESG is an evaluation method that can be used in conjunction with historical fundamental and quantitative methods to identify companies and stocks with the potential for strong performance."


ESG
Sort strong long-term performers from weak ones
Seek strong alpha while balancing investors' values
Exert influence through ownership
3
ESG PILLARS
13
CATEGORIES
200
RISK METRICS
29K+
COMPANIES
33K+
MEDIA SOURCES

Before the invention of modern markets, religious groups like the Quakers and Methodists were early pioneers in the basic principles of responsible investing. But the idea we now know as "ESG" has its roots in a rapid advancement of the movement beginning in the early 20th Century.

Early Activism 1928 - 1970

Focus is on awareness and protest

1928
Religious activism and values-based investing lead to the launch of the first publicly offered socially responsible fund

1960
Labor, shareholder and public activism forced proactive consideration of issues like housing, human rights, civil rights, and anti-war movements

1969
Dow Chemical targeted by shareholder movement for production of Agent Orange

Socially Responsible Era 1970 - 1978

Focus is on corporate divestment and public investment

1970
Investor pressure to divest from apartheid South Africa begins a watershed era for the socially responsible movement

1971
Founding of Interfaith Center on Corporate Responsibility

1973
First community development bank launched

Impact Era 1978 - 1989

Focus is on corporate responsibility and impact

1979
Environmental concern grows after Three Mile Island disaster, followed by Chernobyl (1986) and Exxon Valdez (1989)

1986
Anti-apartheid legislation passes US Congress

1988
Establishment of the UN Intergovernmental Panel on Climate Change

Sustainability Era 1989 - 2004

Focus is on accountability and change

1990
First capitalization-weighted socially responsible Index

1997
Launch of Kyoto Protocols

2004
UN report *Who Cares Wins* published, codifying the meaning and goals of "ESG"

Early ESG Era 2004 - 2018

Focus on asset owners' contribution to ESG outcomes

2006
UN Principles for Responsible Investing

2008
First green bond issuance

2010
Formation of Sustainability Accounting Standards

2015
Bank of England Governor sounds alarm on climate change as a financial stability issue

Intelligent ESG Era 2018...

Focus on integration of ESG as material factor in investment outcomes

2018
- BlackRock CEO calls corporate leaders toward "a sense of purpose"
- EU issues Sustainable Action Plan
- More than 130 ESG disclosure regulations proposed, targeting institutional investors
- China stops accepting 24 types of solid waste exports
- EU implements sustainable finance action plan; drafts European Climate Law

2020
- UK issues "Stewardship Code" tying capital management to "sustainable benefits for the economy and society"
- "Big Data" becomes a $76B industry, growing at 10% annually
- 80% of companies worldwide now report sustainability data
- 40% of companies acknowledge financial risks of climate change

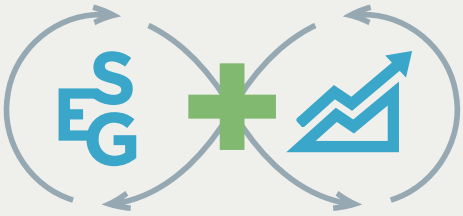
2021
- European Climate Law takes effect
- International Sustainability Standards Board (ISSB) formed to sit alongside the International Accounting Standards Board (IASB)
- Reuters dubs 2021 "the year of ESG investing" as more than $600B flowed into ESG-focused funds
- Global sustainable investment tops $35 trillion, according to the Global Sustainable Investment Alliance

2023
New law (Corporate Sustainability Reporting Directive) to take effect in Europe, increasing the sustainability reporting requirement for large corporations

As ESG evolved, it has gained significantly in its breadth of application. The key driver of ESG's relevance and surging share of global AUM is its powerful positive association with investment performance.

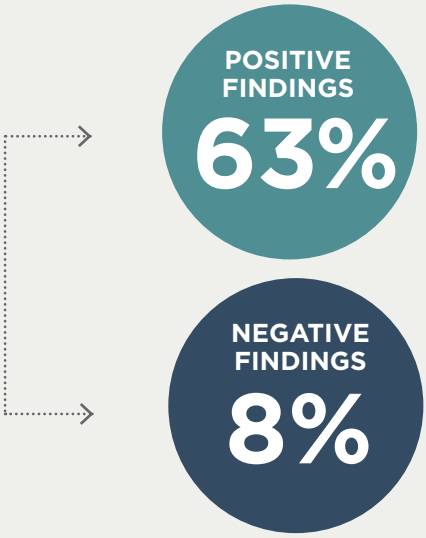
"80% of the reviewed studies demonstrate that prudent sustainability practices have a positive influence on investment performance."

Source: Clark Feiner Viehs; *From The Stockholder To The Stakeholder,* Oxford University & Arabesque Partners, 2014



"Paying attention to ESG concerns does not compromise returns—rather, the opposite."

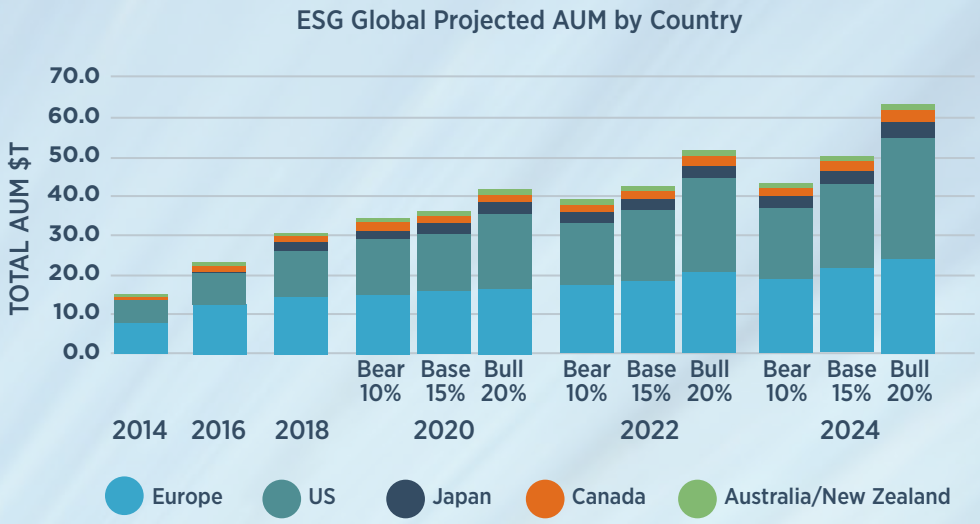
Results of >2,000 studies on the impact of ESG propositions on equity returns



Source: Gunnar Friede et al., "ESG and financial performance: Aggregated evidence from more than 2,000 empirical studies," *Journal of Sustainable Finance & Investment,* October 2015, Volume 5, Number 4, pp210-33; Deutsche Asset & Wealth Management Investment; McKinsey analysis

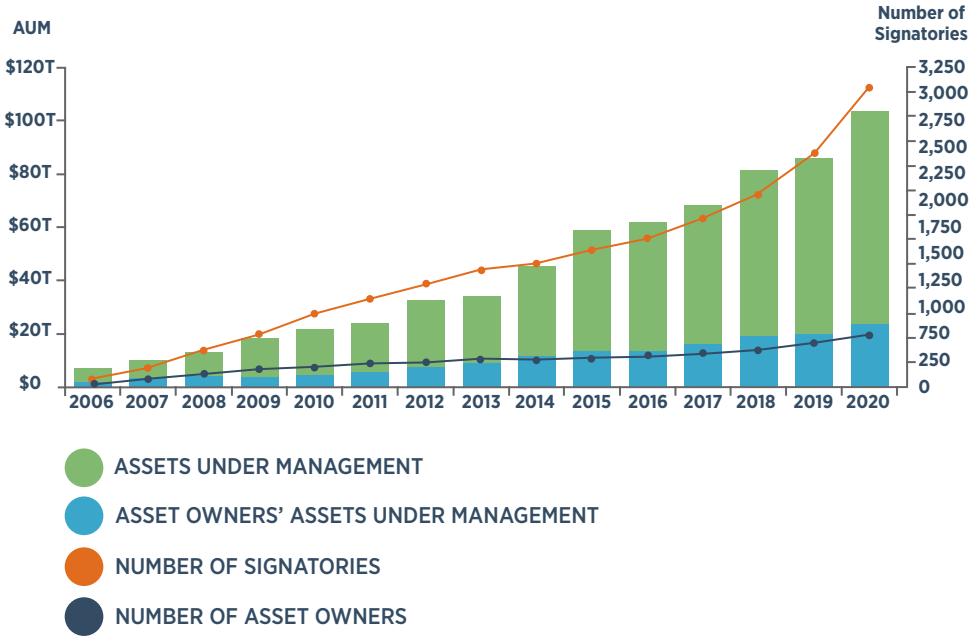
ESG is rapidly becoming an essential tool of investment managers of all kinds. And accelerating asset flows speak to an urgent opportunity that investors should not miss.

According to Bloomberg, assets in ESG strategies may hit $53 trillion by 2024. (see chart below)



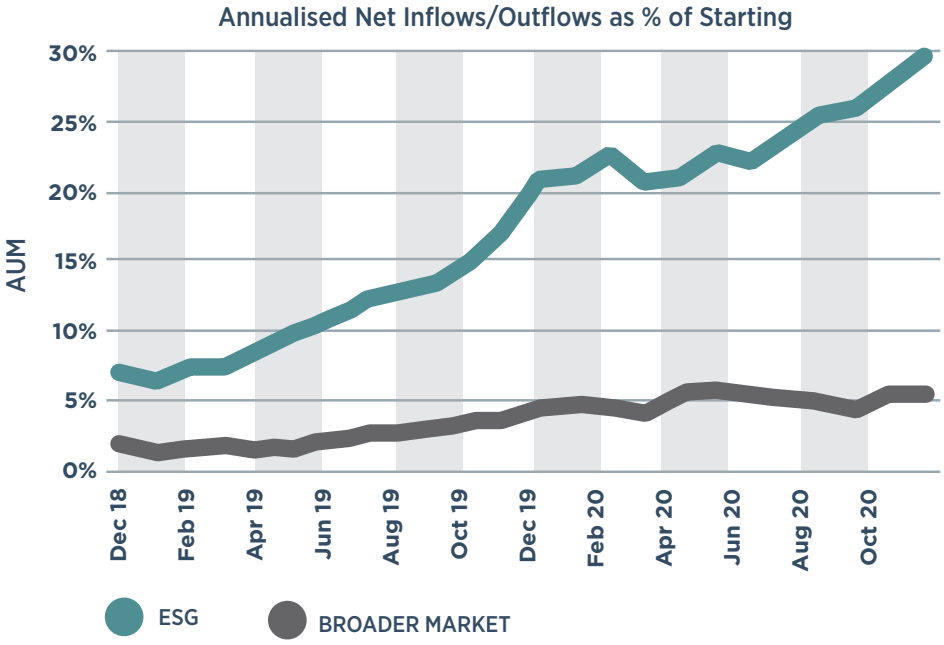
Source: GSIA, Bloomberg Intelligence February 2021

According to the United Nations, as of March 31, 2021, there were more than 3800 signatories to the Principles for Responsible Investment, representing US$121 trillion in assets—a 17% increase from 2020, which itself was 20% above 2019.



Source: UN Principles for Responsible Investing, Annual Report 2020

And ESG asset flows are far outpacing non-ESG flows.



Source: Chen, Mussalli, Behren: "The Unreasonable Attractiveness of More ESG Data"; *Journal of Portfolio Management,* Vol 48, No 1; November 2021

According to our own research, certain ESG factors correlate very strongly with long-term growth of equity value. When integrated into an existing investment process, ESG may help an investment team:

- **IDENTIFY STRONG PERFORMERS** with solid management and sound competitive advantage
- **IDENTIFY COMPANIES** with highly sustainable business models, growth opportunities, and longevity
- **FIND UNCORRELATED SOURCES** of potential alpha
- **REVEAL HIDDEN** operational, financial or reputational risks
- **LOWER VOLATILITY** from negative surprises and news shocks
- **BENEFIT FROM** strong secular fund flows into the ESG space
- **SATISFY A GROWING EXPECTATION** from stakeholders that ESG is "table stakes" for professional investors

In our view, **GOVERNANCE** is the most important element of ESG. Well-run companies are better at managing all aspects of the business, including the "E" (environmental) and "S" (social) factors that impact risk and reward.

$6T =
Est. total cost of cybercrime in 2021

11 seconds =
Est. frequency of cyber attacks in 2021

$9M =
Average cost of healthcare cyber breach in 2021

630% =
Increase in cloud-based attacks in 2020

DATA SOURCES

Cybersecurity is a key component of **GOVERNANCE** in the digital age. Cybercrime is accelerating: companies that manage it well may benefit from a stronger competitive position, better growth opportunities, and superior reputation.

According to a report by Deloitte, companies that fail to manage their cyber exposure can be exposed to severe damage from risks such as:

- Insurance premium increases
- Increase in capital & debt costs
- Operational disruption or destruction
- Lost value of customer relationships
- Lost contract revenue
- Devaluation of trade name
- Loss of intellectual property

GOVERNANCE

The **SOCIAL** element of ESG is vastly under-appreciated by most investors. It's about much more than just the high-profile social justice movements making the evening news.

$1T =
Annual cost of voluntary staff turnover in US

$250K =
Average cost of employment-related court award

1.5B =
Annual work days lost to illness-related absence

425K =
Workers involved in work stoppage 2019 (pre-pandemic)

DATA SOURCES

Labor practices are one example of the wide array of **SOCIAL** issues within the "S" segment of ESG. Labor represents a huge portion of corporate expense, making labor practices a critical component of effective management. Good practices contribute to higher retention, lower turnover, better cost profile, and a stable knowledge and skills base.

Poor management can lead to:

- Walkouts and strikes
- High turnover and expense
- Loss of institutional knowledge and expertise
- Inability to attract talent
- Employee suits, legal expenses and settlements
- Government regulatory and legal actions
- Whistleblowing
- Significant damage to brand and other "intangibles"

SOCIAL

The **ENVIRONMENTAL** element of ESG is probably the most well-known, but also the most misunderstood of all the elements of ESG. It's not about hugging trees. It's about improving the world's economic cost and waste profile, through sustainable use of resources.

715 gallons =
Water req. to make just 1 cotton t-shirt (3 yrs. of drinking water)

4.7M BTU =
Energy req. to make 1 ton of cement

30 tons =
Cobalt ore required for 1 EV car battery

- 75% =
Reduced coal use in ARC furnace v. blast furnace (to make 1,000 kg of crude steel)

DATA SOURCES

Materials are one example of how **ENVIRONMENTAL** issues can play out for different kinds of companies. Those that reduce both consumption and waste will have a stronger cost profile and potentially better growth opportunities, as well as lower regulatory and reputational risk.

Poor management can lead to:

- Higher/rising manufacturing costs
- Increased legal liability
- Legislative scrutiny
- Vulnerability to future regulatory costs
- Significant stranded capital
- Risk of targeted protests and negative news shocks
- Reputational harm

ENVIRONMENTAL

All three core pillars of ESG can be broken down into multiple component parts. And today, the field of ESG might include hundreds, if not thousands of individual "factors."

E

- Climate Change Mitigation
- Product CO2 Emissions
- Supplier Waste
- Supplier Water Stress
- Supply Chain Waste
- Brown Energy
- Consumption
- Packaging Waste
- E-Waste
- Biodiversity
- Habitat Loss
- Spills & Discharges
- Land & Bio Impact
- Ecosystem Destruction
- Water Use

S

- Wage Levels
- Working Conditions
- Labor Rights
- Supplier Human Rights Impact
- Diversity
- Opportunity
- Discrimination
- Health & Safety
- Marketing & Sales Practices
- Fraud
- Product Recalls
- Product Quality
- Public Health Impacts
- Local Impact

G

- Management Compensation
- Board Compensation
- Shareholder Rights
- Insider Dealings
- Anti-Competitive Practices
- Intellectual Property
- Cyber Security
- Lobbying
- Accounting Integrity
- Financial Reporting
- Supplier Ethics
- Tax Evasion
- Money Laundering
- Business Ethics
- Corruption
- Child Labor

But effective use of ESG comes from skillful application of the metrics and data, understanding...

each factor's
materiality & correlation

TO

each company
& its stock performance.

That is: How relevant is any given ESG factor to the company's operations and financial success? And how well does that factor correlate to the company's stock performance?

Using ESG data analysis, investors may gain valuable insight into...

- Overall investment risk/reward
- Management strength
- Business model sustainability
- Competitiveness & growth potential
- Corporate citizenship
- Operational, reputational, regulatory and other risks
- Transparency on key performance metrics
- Likely cost and availability of capital

And where ESG scores/rankings indicate poor absolute or relative performance, the framework enables investors to hold management accountable and influence the future trajectory of the company.

So, while misunderstandings about ESG still persist, it is definitely...

NOT

- **NOT** exclusionary
- **NOT** divestment
- **NOT** politics
- **NOT** environmentalism
- **NOT** a “screen”
- **NOT** a moral judgment
- **NOT** a discount to performance
- **NOT** a separate asset class or “carve out”

And those who do not engage with this powerful new tool may be facing significant...

Opportunity cost

- Overlooking key areas of corporate strength or advantage
- Missing sectoral or industry growth trends
- Following (rather than leading) flows into the ESG space

Embedded Risks

- Regulatory/legislative risks
- Higher cost of capital / lower liquidity for poor performers
- Risk to growth in a changing world
- Reputational risks (negative headlines/shocks)
- Higher input costs (e.g., carbon pricing)
- Over-investing in underperformers

Missed Market Expectations

- Increasing focus on ESG reporting for money managers
- New generation of investors with higher expectations
- Increasingly standard part of investment policy/guidelines

We now know for a fact that the way a company conducts itself—the integrity of its governance, treatment of the environment, resource consumption, treatment of its workforce and other stakeholders, and its performance as a citizen—can have a large impact on its competitive position and long-term viability, as well as its financial results and stock performance.

For this reason, ESG is an irreversible secular trend that's changing investor attitudes and behaviors, moving markets, and redefining the path to investing success.

It's relevant to **EVERY** investor and will likely impact **EVERY** part of a diversified portfolio, in **EVERY** asset class... equities, fixed income, alternatives, and real assets.

As a fiduciary, if your mandate is to deliver long-term portfolio growth, then talk to us about the potential for ESG to help you deliver.

ICM's investing principles are built on decades of experience—rooted in leveraging technology for research, risk, and operations, along with a strong track record in creating long-term investment solutions.

Curt Brockelman
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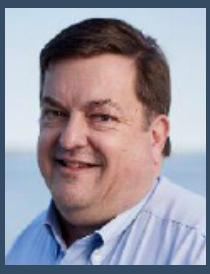

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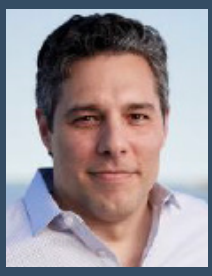

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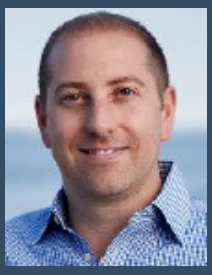

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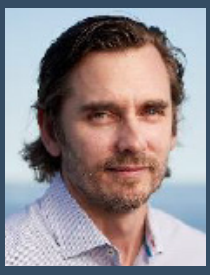

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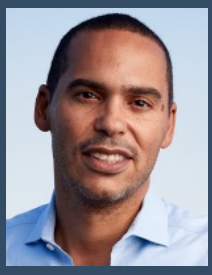

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