Intersect Capital Management

ESG & Fiduciary Duty: Growing relevance in an evolving world

INTELLIGENT ESG: An educational series from Intersect Capital Management

As fiduciaries, we live in a rapidly evolving world.

One of the places that change is being felt most acutely is in the ESG space.

But the results are in, and the message is clear.

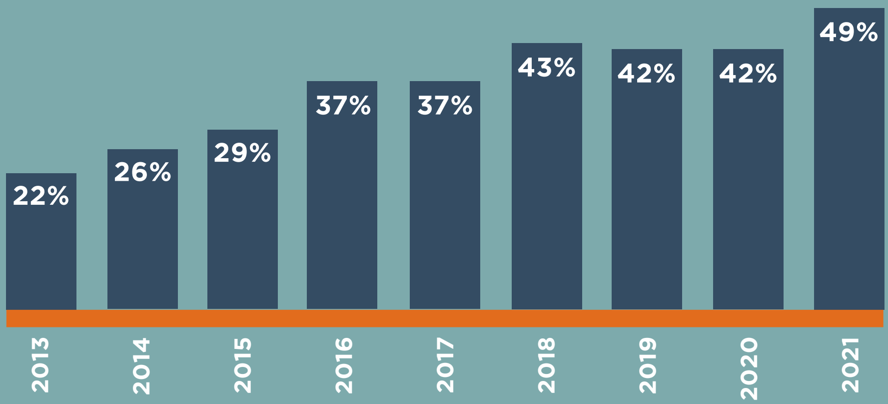
ESG is here to stay.

According to Callan, ESG use among institutional investors has more than doubled over the last eight years.

123%

increase in respondents that have incorporated ESG factors into investment decisions from 2013.

ESG Adoption Over History of Callan ESG Survey



Source: Callan Institute; *2021 ESG Survey*

Today, the majority of large investors incorporate ESG at some level of the investment process:

72%

of large investors (>$20bn) have incorporated ESG factors into investment decisions.

61%

of those that incorporated ESG considered ESG factors with every investment/ manager selection.

Much of that gain was made in the last 5 years, with much more to come:

55%

of those incorporating ESG did so in the past five years.

40%

of respondents not incorporating ESG factors into investment decision-making were considering doing so in the near future.

Source for all data points: Callan Institute; *2021 ESG Survey*

The question is WHY?

What's driving the rapid adoption of ESG among institutional asset owners?

Answer: An Evolution of Markets & Fiduciary Duty

As markets have evolved over many decades, we have seen a steady evolution in the scope of our fiduciary duties, as well as how those duties are executed.

STOCKS WERE ONCE CONSIDERED TOO RISKY

Public equities were once considered inappropriate for pension investing, but since the 1970s, they have dominated pension asset allocations, with pension funds even acting as a key source of capital for a wide range of alternatives, like REITs, private equity, and hedge funds.

PENSION FUNDS USED TO BE VIEWED MORE LIKE BANKS AND INSURERS

Before the 1980s, investment options for many State pension plans were legally limited to holdings similar to those of insurance companies and savings banks.

“PORTFOLIO” MANAGEMENT WASN’T ALWAYS THE STANDARD

In 1992, the Uniform Prudent Investor Act established a “total portfolio approach” to fiduciary duty, eliminating category restrictions on different types of investments.

MODERN PORTFOLIO THEORY WASN’T ALWAYS THE MEASURE OF SUITABILITY & PRUDENCE

The American Law Institute’s Restatement (Third) of Trusts in 1992 established Modern Portfolio Theory (MPT) as a proper test of fiduciary duty for investments. And today many argue that MPT’s utility should be reappraised.

THE DEFINITION OF INVESTMENT ADVICE IS STILL EVOLVING

In 2016, The DOL issued its “2016 Rule,” replacing the five-part test of the “1975 Rule,” broadening the definition of investment advice for pensions and retirement plans, while also creating carve outs for investor education.

Today, fiduciary duty is a key driver in ESG adoption

As fiduciaries, investment professionals have an obligation—in fact we hold to a broad mandate—to use every advantage at our disposal, to use every tool in the toolbox, to fulfill our long-term responsibility to clients.

The United Nations Principles for Responsible Investing (UNPRI) believes that ESG is an important material factor in investment outcomes, making it essential to the fiduciary's objective.

Evolution of the case for ESG incorporation into the investment process, according to a UNPRI report:*

ESG incorporation is not prohibited by ERISA →

ESG incorporation creates clear benefits for investors →

ESG incorporation is a core element of fiduciary duty

*Untangling Stakeholders for Broader Impact ERISA Plans and ESG Incorporation—*UN Principles for Responsible Investment Report, 2017*

“There is now a compelling body of evidence that ESG issues can drive investment value and/or that the failure to effectively manage ESG issues can destroy investment value.”

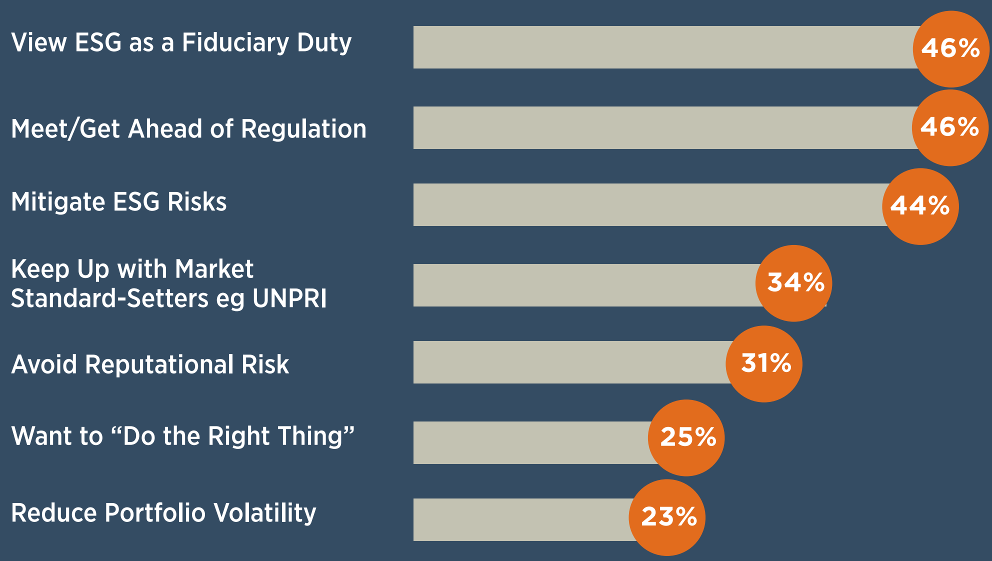
Source: UN Principles for Responsible Investing; *Fiduciary Duty in the 21st Century Final Report*

UN PRI’s support for that statement includes:

- **Positive correlation** between ESG and corporate financial performance
- **Better access** to finance for companies with better ESG performance
- **Significant investment** opportunities associated with ESG issues
- **Significant consequences** for failing to manage ESG-related risk
- **Outperformance of firms** with good ESG ratings on material issues

According to State Street:
"Once an uncertainty for many investors, the fiduciary duty aspect of ESG is fast becoming more certain, with 46% of respondents seeing it as the key driver of adoption."

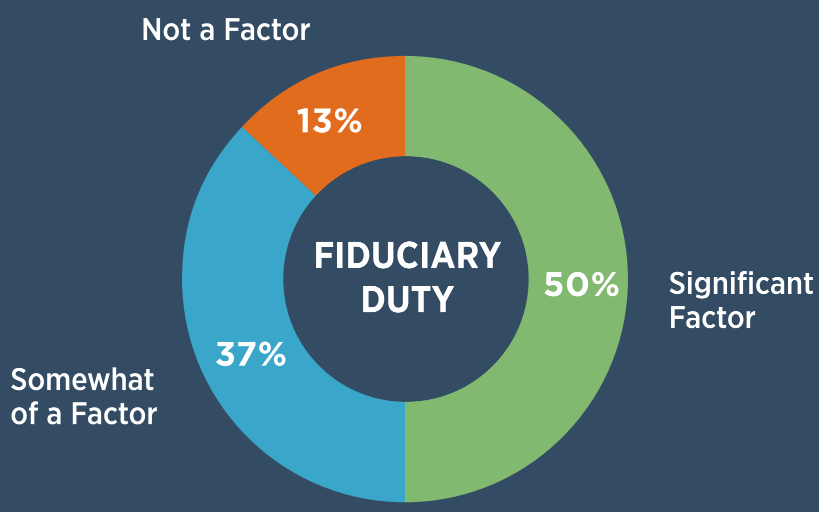
What are the most significant factors in driving your institution to adopt ESG principles?



Quote and data source: State Street Global Advisors Report, *Into the Mainstream: ESG at the Tipping Point, 2019*

According to Cerulli Associates: "Fiduciary Duty is the biggest factor driving usage of ESG criteria for asset owners."

Asset Owners: Factors Driving Decision to Start Using ESG Criteria in Investment Analysis, 2019

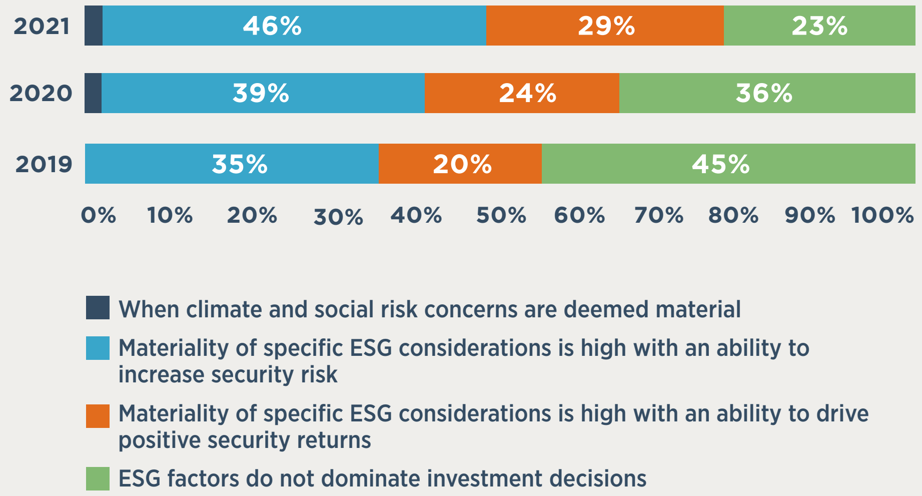


Quote and data source: The Cerulli Report—*U.S. Environmental, Social, and Governance Investing 2019: Meeting Evolving Investor Expectations*

Materiality: The link between ESG and fiduciary duty

ESG's relevance to fiduciary duty derives from its role as a material factor that impacts an investment's performance potential.

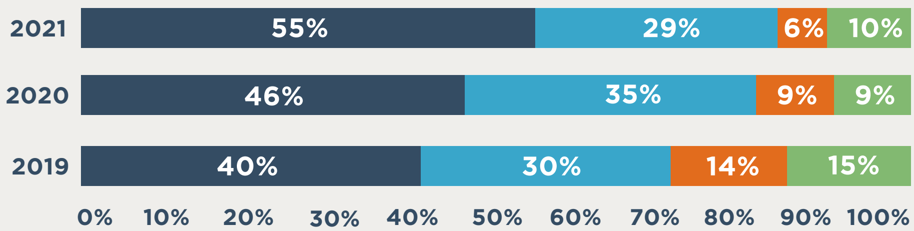
How do you determine when ESG Factors should dominate the investment decisions?



Source: Russell Investments; *2021 Annual ESG Survey; The red flag is raised on climate risk*

The majority of money managers implementing ESG—many of whom are fiduciaries themselves—have built internal expertise to assess materiality.

How do you form your ESG Insights?



- Primarily rely on internally-produced quantitative data but use externally-produced quantitative data to a lesser extent
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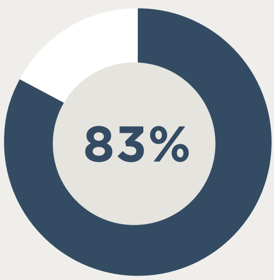
- Solely rely on internally-produced quantitative data
- Solely rely on externally-produced quantitative data (i.e. Sustainanalytics, MSCI, etc.)

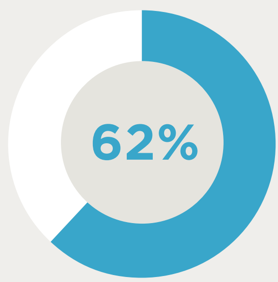
Chart source: Russell Investments; *2021 Annual ESG Survey; The red flag is raised on climate risk*

In fact, the dominant approach to addressing ESG's materiality now means fully integrating ESG factors into the fundamental research process.

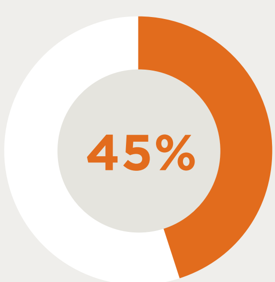
Most Asset Managers Embed ESG Data into Fundamental Analysis



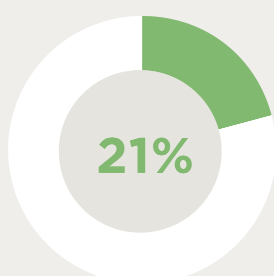
ESG is embedded into firm's fundamental analysis



Offering investment products developed from ESG criteria (e.g. clean energy fund)



ESG analysis as a complement to fundamental analysis



ESG analysis as an overlay to fundamental analysis

Source: The Cerulli Report—*U.S. Environmental, Social, and Governance Investing 2019: Meeting Evolving Investor Expectations*

Whether it's your Board of Directors, external stakeholders, outside asset managers, or your peers... most of them now see ESG integration for what it is: inevitable.

And as the evolutionary process continues, fiduciaries should expect:

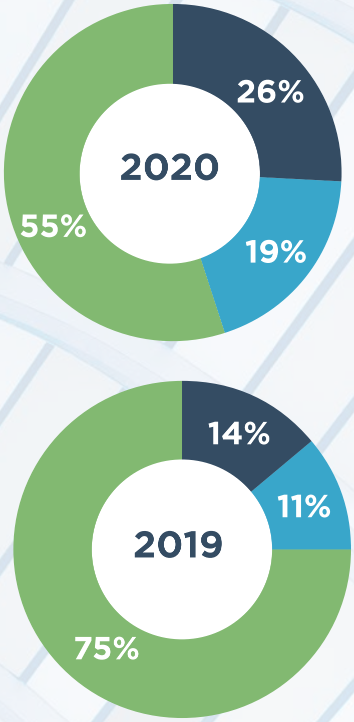
Increased reporting requirements + **Tightening regulation** + **Vastly changed attitudes & expectations**

Requirements are increasing...

Fiduciaries who think ESG won't impact them have been mistaken in the past:

- **In 2019, a quarter of those who thought that they would face no ESG requirements turned out to be wrong.**
- **Those facing ESG requirements, and those expecting to, about doubled in one year, from 2019 to 2020.**

Is your organization required to invest in socially responsible products, or do you anticipate being required to do so in the next two years?



- Currently required to invest
- Anticipate to be required to invest
- Not required to invest; do not anticipate to be required

Source: Ernst & Young; *EY 2020 Global Alternative Fund Survey*

Regulations are tightening…

The trend is building in Europe first, but global harmonization won't likely be far off: "The ESG reporting landscape is now rapidly moving toward globally harmonized disclosure standards."[1]

Some expected changes include[2]:

- **Data disclosure regulation**
- **Taxonomy regulation**
- **Due diligence laws**
- **Updated UCITS directives**
- **Corporate governance codes**
- **Carbon pricing**
- **ESG stress testing**

[1] Deloitte; Tectonic shifts: *How ESG is changing business, moving markets, and driving regulation; October 29, 2021*
[2] Hogan Lovells; *New and Emerging ESG Laws; 2021*

Just like a bond investor needs to report on credit quality, fiduciaries may soon be expected to have ready access to comprehensive data about ESG performance across all their holdings.

And data standards will likely cover multiple dimensions of the ESG investment proposition:

REPORTING ESG DATA
publicly and in a straightforward, transparent way

TRACKING ESG DATA
and whether it shows improvements over the long-term investment horizon

QUANTIFYING ESG IMPACT
of investment portfolios in terms like carbon footprint, resource extraction/sustainability, water usage, and other relevant metrics

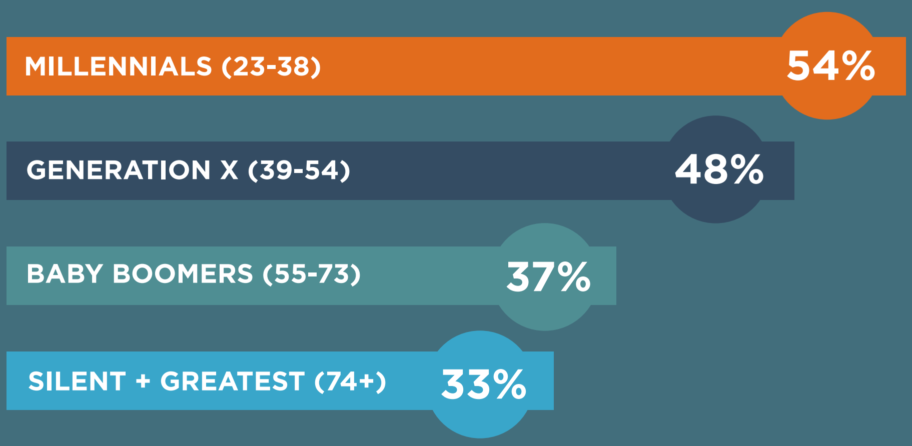
And attitudes are changing (fast)...

According to Nuveen's 6th Annual Responsible Investing Survey, Millennials have much higher expectations compared to non-Millennials. **They represent the next generation of leaders, executives, regulators, legislators, and investors, and they care deeply about such issues:**

	Strongly/Somewhat Agree (net)	
	Millennial	Non-Millennial
Advisors who discuss responsible investing with investors are more forward-thinking	93%	76%
I would be more comfortable working with an asset manager that had experience in responsible investing	94%	73%
It is important to me that my asset manager is knowledgeable about responsible investing	96%	72%
Recent climate-related natural disasters have made me more interested in responsible investing	85%	59%

With the next generation comes a building wave toward ESG as "table stakes" in investing.

Retail Investors: Preference for Positive ESG Themes by Generation, 1Q 2019



Source: The Cerulli Report—*U.S. Environmental, Social, and Governance Investing 2019: Meeting Evolving Investor Expectations*

“Boards and C-suites that can get ahead of ESG disclosure regulation can build a business that meaningfully integrates ESG into its strategic planning and is better poised to manage risks while also delivering shareholder value and increasing their organization’s resiliency in a changed world.”

Deloitte; Tectonic shifts: How ESG is changing business, moving markets, and driving regulation; October 29, 2021

This is the compelling new world in which fiduciaries operate. It may feel strange, as all changes do at first.

But we believe ESG is just one more chapter in the ongoing, evolving story of fiduciary duty. And as a recent Deloitte report pointed out: “There is no going back on ESG.”

At a minimum, asset owners and money managers should expect stricter reporting requirements as a wide range of stakeholders increasingly expects, even demands it.

But more than that, we believe ESG can have a dramatic positive impact on the fiduciary’s mission of high compounded growth with attractive risk-adjusted returns.

IF YOU’D LIKE TO DISCUSS HOW, WE’D BE GLAD TO HELP.

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ENVIRONMENTAL, SOCIAL, AND GOVERNANCE GUIDELINES: The Fund evaluates financially material ESG factors as part of the investment decision-making process, considering a range of impacts they may have on future revenues, expenses, assets, liabilities and overall risk. There is no guarantee that the ESG strategy will be successful.

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