Frequently Asked Questions About ESG Investing

pfm asset management

Organizations considering an environmental, social and governance (ESG) investment approach may ask many questions prior to adopting and implementing an ESG strategy. These questions should aspire toward gaining a deeper understanding of ESG investing itself and the impact such an approach may have on investment opportunities and performance. Another priority is familiarizing the investor with strategy options, the steps involved in developing and implementing an ESG approach and effective monitoring practices.

The questions and brief answers below are intended to provide general guidance for frequently asked questions.

What is ESG investing?

While there isn't one universally accepted definition, ESG investing generally refers to the process of incorporating non-financial environmental, social and governance factors into an investment analysis alongside traditional financial criteria.

How is ESG performance evaluated?

ESG performance evaluations typically focus on exposure to and management of material ESG risks. Material ESG risks are risks that could significantly impact an organization's enterprise value and operating performance if they are not effectively managed. Some risks are unmanageable (i.e., greenhouse gas emissions from airplanes in flight). Material ESG risks vary by organization and are largely dictated by an organization's business activities. The chart below provides examples of commonly scrutinized ESG risk factors:

Environmental	Social	Governance
how a company interacts with nature and earth's resources	*how a company treats its employees, community, customers, and other companies with which it interacts*	*how a company is led and managed, including executive pay and any internal controls*
Climate Change	**Data Protection**	**Board Composition**
Air Pollution	**Community Relations**	**Lobbying**
Deforestation	**Gender & Diversity**	**Bribery & Corruption**
Water Pollution	**Human Rights**	**Executive Comp.**

How does ESG investing differ from other sustainable investment approaches?

Because of its wider evaluation of ESG-related risk exposure, ESG investing is generally **broader in scope** than other sustainable investment approaches, such as socially responsible investing (SRI), impact investing, and thematic investing. SRI is exclusionary in nature, with the objective of avoiding certain companies and/or whole industries (e.g., fossil fuels). Impact and thematic investing are typically more narrowly focused. Impact investing seeks to achieve a specific social or environmental objective while also earning an acceptable financial return through direct investment in a company or project. Thematic investing seeks to deploy capital to companies and industries that support specific sustainability-aligned missions, such as affordable housing, clean energy, etc.

Can ESG investing be combined with other sustainable investment approaches?

Yes. Approaches are not mutually exclusive. They are often combined in some form to enable investors to achieve their unique sustainable investment objectives.

Does adopting an ESG strategy mean there can be no investment in fossil fuels and/or other "controversial" industries?

No. ESG investing can be approached in many ways. While investors often equate ESG investing with prohibiting certain issuers and industries, investment exclusions are often at the investor's discretion. ESG strategies can be designed to include fossil fuel companies, provided those companies satisfy the investor's ESG requirements.

Can you provide examples of ESG approaches?

ESG approaches typically utilize a positive screening methodology for the "best-in-class" indices.[1] Investment eligibility is determined by evaluating a company's ESG performance and ESG risk profile. ESG approaches may also include exclusionary or negative screening options to restrict particular companies or industries. More nuanced ESG strategies may limit investment eligibility based on specific environmental, social or governance risk factors.

What types of fixed-income funds employ ESG strategies?

While ESG and other sustainable investment strategies are commonly applied to equities, adoption in the fixed-income space is growing. ESG strategies can be applied to virtually any type of fixed-income oriented fund that is permitted to invest in corporate securities, including **operating funds, bond proceeds and reserve accounts.** For these funds, issuers of credit instruments are typically analyzed from an ESG perspective to determine eligibility.

What impact could an ESG strategy have on available investments?

As discussed, ESG strategies typically focus on identifying permitted investments with acceptable ESG risk profiles. This approach is likely to reduce the universe of permitted investments. The degree of this reduction depends on the specific ESG investment requirements. Therefore, it is important to understand the impact of any ESG strategy under consideration on permitted investments.

1 Source: ICE Data Services, "Introducing the ICE ESG Bond Index Family," published July 16, 2020. ESG Risk Rating Criteria: Excludes issuers with high and severe risk (an ESG Risk Rating >=30 on a scale of 0 to 100); Controversial Weapons Involvement Criteria: Excludes issuers with a Controversial Weapons involvement of medium, high, or severe (a Controversial Weapons score >=20).

For fixed-income ESG strategies, PFMAM analyzes the impact of an ESG approach on eligible investments to evaluate the portfolio's ability to achieve its primary investment objectives.

Has there historically been an investment performance trade-off for those that adopt an ESG approach?

Many investors are understandably concerned about the potential impact of an ESG approach on investment performance. However, as indicated below, the performance of investment-grade ESG and non-ESG fixed-income indices has been similar over the five-year period ended December 31, 2021.

	Historical Return Comparison (January 1, 2017 – December 31, 2021)			
	Master ESG Corporate Index	Master Non-ESG Corporate Index	1-5 Year ESG Corporate Index	1-5 Year Non-ESG Corporate Index
Since Inception Annualized Return	5.32%	5.27%	3.19%	3.19%

Source: Bloomberg. Master ICE U.S. Corporate Best-in-Class ESG Index, Master ICE BofA U.S. Corporate Index, ICE US 1-5 Year Investment-Grade Corporate Best-in-Class ESG Index, and ICE BofA 1-5 Year Investment Grade U.S. Corporate Index. Inception date is December 31, 2016.

Please note that investment results (and future results) are not guaranteed and will also vary depending on traditional market factors such as duration positioning, portfolio composition, credit quality, and changes in interest rates and yield spreads.

For more information about how sustainable approaches impact performance, please ask your PFMAM representative to send you our InvestEd article, *Fixed Income Investing: How Does ESG Impact Performance?*

Why should our organization consider an ESG or other sustainable investment approach?

There are several reasons why organizations may consider implementing a sustainable investment approach. Non-investment management-related reasons include better alignment of investment objectives with an organization's mission or core values and a desire to avoid investment in companies that may be considered controversial. Investment management-related reasons include a broader focus on risk management and an opportunity to potentially generate higher risk-adjusted returns.

What sustainable investment strategy is most appropriate for our organization?

The answer depends on your organization's sustainable investment objectives. PFMAM will work with your organization to create a tailored approach.

Is it possible to customize our approach?

Yes. Our sustainable investment solutions are customizable.

If our organization is interested in an ESG approach, what are the next steps?

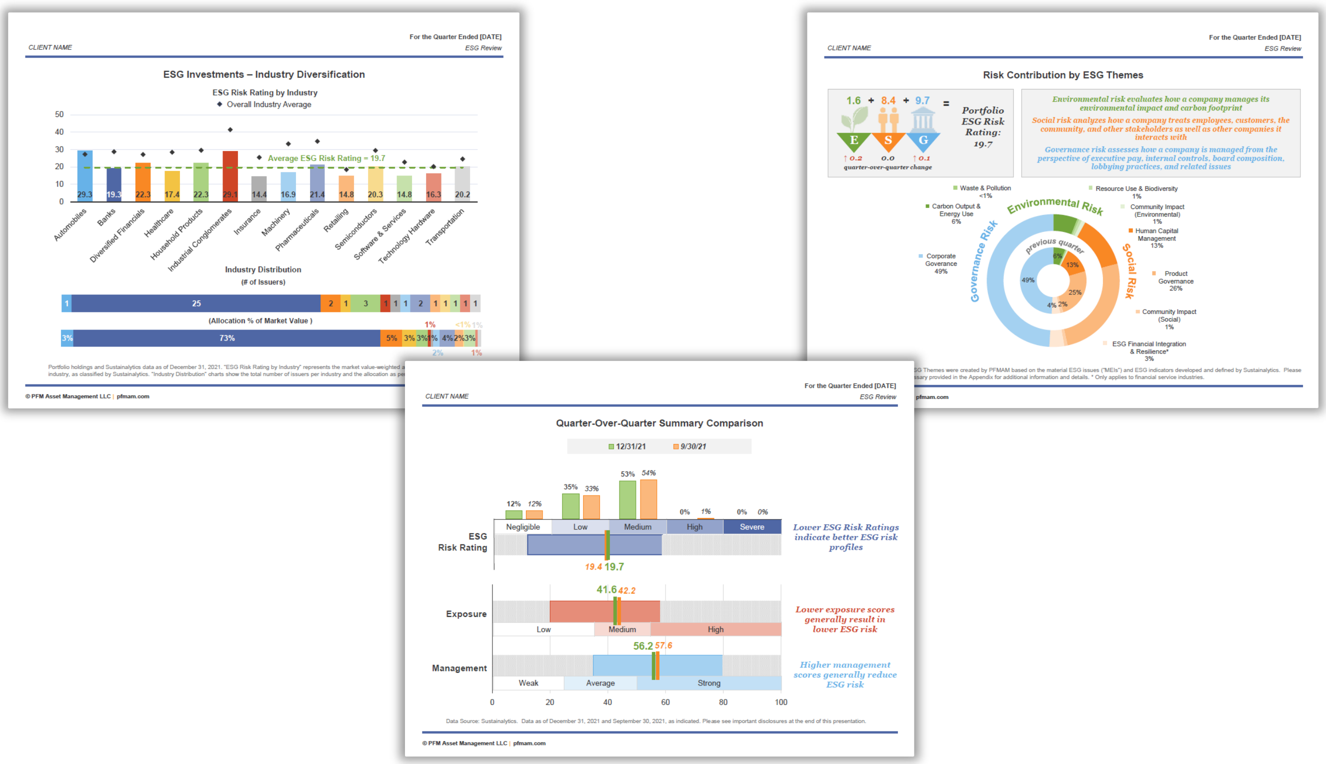
We generally employ and recommend the following steps to help organizations develop, evaluate, implement and effectively manage ESG strategies:

- Identify Sustainable Investment Priorities & Objectives
- Review ESG Investment Approach Options
- Develop & Define ESG Investment Parameters
- Evaluate ESG Integration Impact
- Update the Investment Policy
- Integrate ESG into the Investment Process
- Continually Monitor Results and Revise Approach as Needed

This process and approach helps enable organizations to develop and implement ESG investment solutions customized to their sustainable investment objectives. This dynamic approach also provides organizations with the flexibility to modify their ESG strategy as their sustainable investment objectives evolve.

How can we monitor our ESG strategy and the ESG status of our investments?

We recommend periodic evaluations of the adopted ESG strategy. To assist our clients with ESG assessments, PFMAM provides ESG-focused reporting, typically on a quarterly basis. Our reports provide an in-depth assessment of several key ESG metrics, including the portfolio's ESG risk profile and risk contribution by ESG pillar, as well as industry, sector, and issuer level ESG risk assessments.



Conclusion

PFMAM works closely with our clients to help them develop and implement customized ESG strategies. This dynamic approach also provides our clients with the flexibility to modify their ESG strategy as their sustainable investment objectives change over time.

We look forward to speaking with you about your sustainable investment objectives and answering your questions about ESG and other sustainable investment solutions. For more information about how we can help you incorporate your ESG goals into your investment program, please contact your PFMAM representative or reach out to David Reeser.

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To learn more or discuss in greater detail, please contact us:

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NOTE:

There is no guarantee the investment objectives will be achieved as the investment portfolio will only include holdings consistent with the applicable Environmental, Social, and Governance (ESG) guidelines. As a result, the universe of investments available will be more limited. ESG criteria risk is the risk that because the investment portfolio ESG criteria excludes securities of certain issuers for non-financial reasons, the investment portfolio may forgo some market opportunities that would be available to investment portfolios that do not apply ESG criteria.