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ESG

POLARIZATION OF ESG

OCTOBER 2023

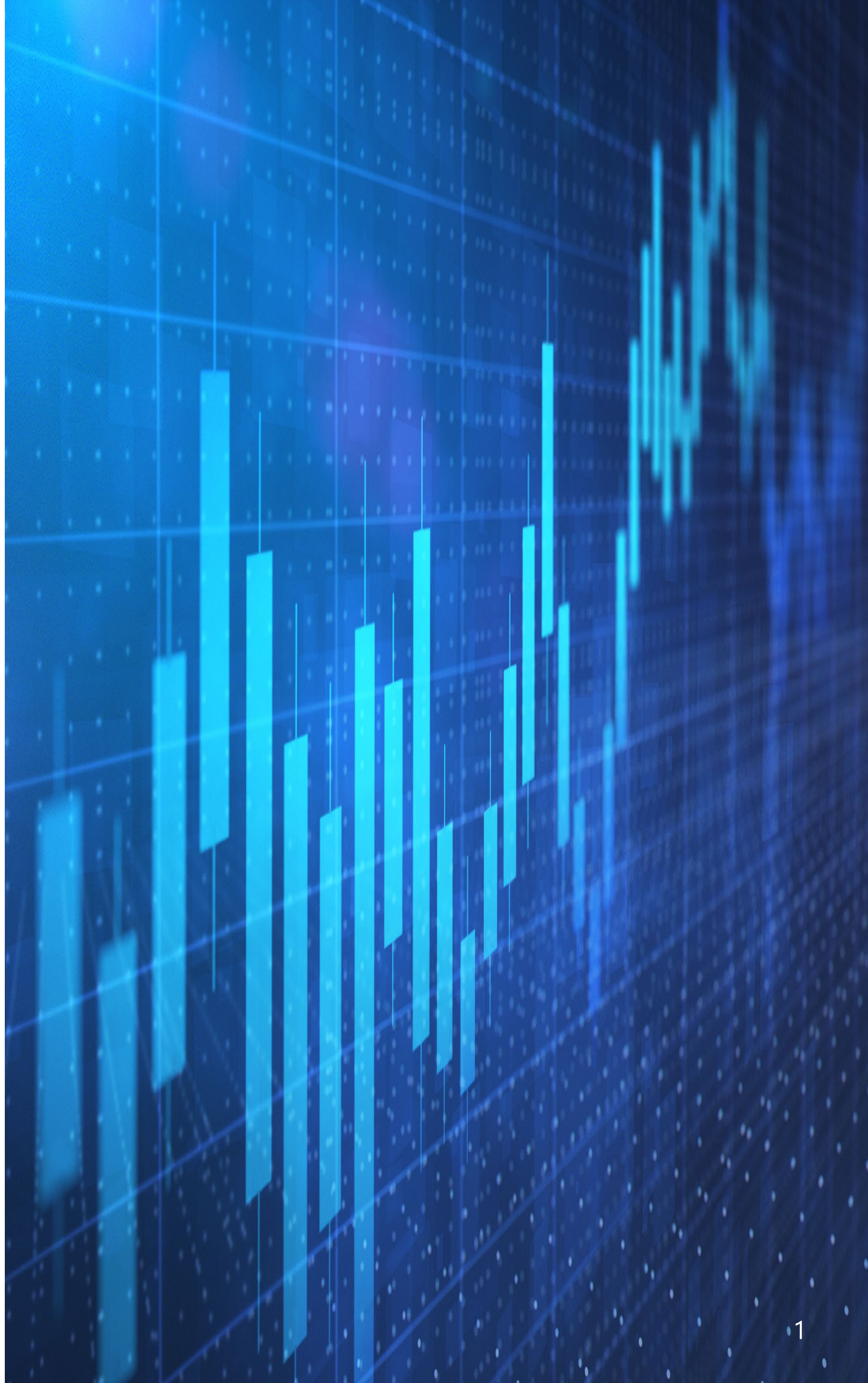
AGENDA

1 **Polarization of Environmental, Social, and Governance (ESG)**

2 **What is ESG Investing?**

3 **Case for ESG**

4 **Considerations**



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ESG HISTORY

ESG investing has a long history from values alignment to frameworks focusing on evaluating environmental and social risks on financial performance. To date, there is no universally agreed upon ratings framework or standardized reporting methodology.

Values

ESG Risk Management

- **1960/1980s - Responsible Investing/Exclusionary Screening**
  - Investor specific values.
- **1997 - Global Reporting Initiative (GRI)**
  - Created an accountability framework for companies to display to their stakeholders their responsible environmental business practices. *MSCI Ratings*
- **2000 - Carbon Disclosure Project (CDP)**
  - Goal to transform capital markets by shifting businesses to prioritize environmental reporting and risk management. *Sustainalytics Ratings.*
- **2006 - UN Principals for Responsible Investment (UNPRI) report**
  - First time considered as part of the financial evaluations of companies. *FTSE Russell Ratings*
- **2011 Sustainability Accounting Standards Board (SASB)**
  - Develop standards that display both sustainability and financial fundamentals. Goal was that investors could compare performance on critical social and environmental issues. *RepRisk Ratings*

Climate

- **Taskforce on Climate Related Disclosures (TCRD)**
  - Framework for companies to report climate-related financial risks, physical, transition, and transition, to shareholders. *ISS Ratings*

Sources: Syntrinsic, Forbes

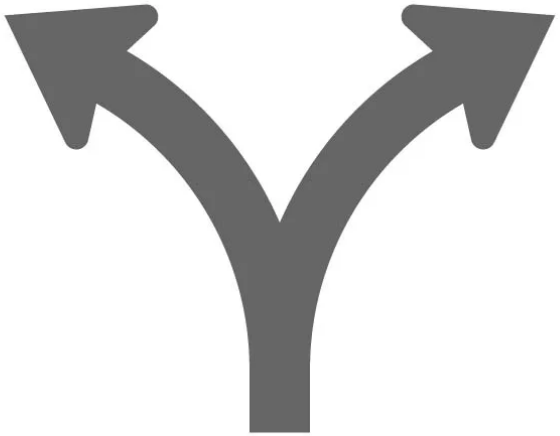
INVESTOR POLARIZATION

As ESG investing has evolved from the 1980s there have been critics on either side of the spectrum of investing. There is a belief from some investors that just using material ESG factors in decision-making isn't enough for people and planet and a belief from other investors that using ESG factors in decision-making limits financial performance.

Values - Aligned Investors

Evaluating financial data and all ESG issues to have a positive impact people and planet

ESG Integration



Evaluating financial data + material ESG issues to improve risk adjusted returns

Anti-ESG Investors

Evaluating only financial data in decision-making maximizes returns

Material ESG issues are factors that are likely to affect the financial condition or operating performance of a business within a specific sector. Material ESG issues differ by sector.

POLARIZATION OF ESG - CLIMATE

Values - Aligned Investors

Based on research, values aligned investors for many years have been concerned about "ESG Greenwashing" and that not evaluating all ESG factors is counter to fiduciary duty. Key issues include:

- ❖ Climate disclosures are not sufficient and do not hold companies accountable for their impact on the planet
- ❖ Companies that have a negative impact on people and planet, specifically fossil fuels emitters, should have a low ESG rating and/or be excluded from portfolios
- ❖ ESG ratings only focuses on "material" ESG factors and do not consider outcomes on people and planet
- ❖ No agreed upon framework for ESG ratings and highly subjective

Anti-ESG Investors

Based on research, Anti-ESG backlash began in earnest in 2021, with concerns about a liberal agenda, and "woke" capitalism that some perceive to be counter to fiduciary duty.

"Anti-Woke" issues include:

- ❖ Political movements that are in direct opposition to maximizing returns
- ❖ Reducing fossil fuel emissions increases energy prices, drives inflation, and is economically destructive
- ❖ ESG investing weakens the national security of the United States

General Anti-ESG issues include:

- ❖ Ignores the interests of shareholders which is make as much money as possible (Milton Friedman)
- ❖ Investing in companies with high ESG ratings could lead to portfolios that exclude sectors (e.g., energy) and are potentially more concentrated (e.g., IT, consumer disc.)
- ❖ No agreed upon framework for ESG ratings and highly subjective

Sources: Bloomberg, Forbes, WSJ, Harvard Law School Forum, Syntrinsic, NYT, and other news publications. "Anti-Woke"- Movement created in 2022 around the Stop the Woke Act

POLARIZATION OF ESG – DIVERSITY, EQUITY, AND INCLUSION

Values Aligned Investors

Based on research, values-aligned investors have been concerned about "ESG Greenwashing" when it comes to DEI. Key issues include:

- Ratings do not penalize companies for discrimination practices in the workplace and the effects of companies' activities on underserved communities unless a material issue
- Companies have been using DEI initiatives as "greenwashing" and no real progress has been made
- No standardized metrics for tracking DEI within a company

Anti-ESG Investors

Current, DEI concerns have been led by "Anti-Woke" investors. Based on research, these activist investors have been increasingly filing shareholder proposals to put anti-DEI proposals to a vote. In addition, activists have been requesting that the EEOC open civil rights investigations. Key issues include:

- DEI policies and practices impact civil rights and are discriminatory
- DEI initiatives do not prioritize returns nor does it maximize the value for shareholders

Sources: Bloomberg, Forbes, WSJ, Harvard Law School Forum, Syntrinsic, and other news publications

WHAT IS ESG INVESTING?

INCORPORATING ESG FOR RISK MANAGEMENT

+ **Stock/Investment Manager Selection (Bottom-up Selection)**
  - Including material ESG factors in the investment analysis to access risks.
  - MSCI, Sustainalytics, Bloomberg, and other rating agencies provide ESG ratings on individual securities.
+ **Portfolio Construction (Top-Down Selection)**
  - Using ESG factors to identify macroeconomic and financial risks for the capital markets and create portfolios that mitigate some of those ESG risks.

Source: MSCI

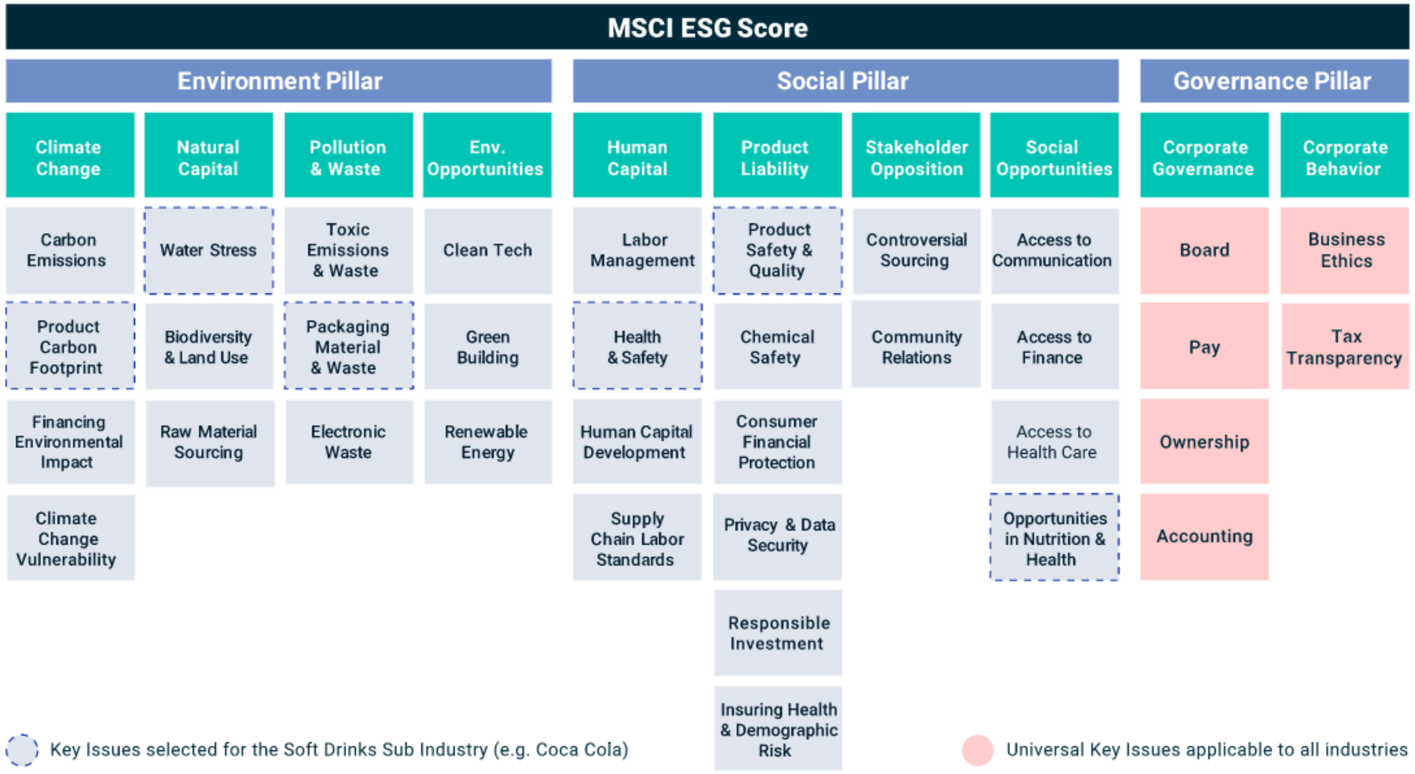
INCORPORATING ESG FOR VALUES ALIGNMENT

+ **Stock/Investment Manager Selection (Bottom-up Selection)**
  - Invest in companies that score well based on material ESG factors relative to their sector and invest in companies that also score well on values aligned issues (e.g., climate change, racial and gender diversity, etc.).
  - MSCI, Sustainalytics, Bloomberg, and other rating agencies provide ESG risk ratings on individual securities but do not provide ratings that are values aligned. **This is more subjective.**
+ **Portfolio Construction (Top-Down Selection)**
  - Using ESG factors to identify macroeconomic and financial risks for the capital markets and create portfolios that mitigate some of those ESG risks and benefit from investment in values aligned themes such as gender diversity, racial equity, education, sustainable communities, affordable housing, etc.
+ **Active Ownership**
  - Engage in shareholder advocacy to support values aligned issues.

Examples of Values Aligned Themes

RISK RATINGS FRAMEWORK - MSCI

There are many different ESG ratings providers; some of the largest are MSCI, Sustainalytics, and ISS. MSCI's ratings methodology is below, the ratings are based data collection. The framework is designed to rate the financially relevant (material) ESG risks and opportunities for a company (not all factors).



Source: MSCI

PUBLIC PORTFOLIO RISK EXPOSURE - MSCI

Below is an example of key risk factors within a global equity portfolio compared the benchmark (MSCI). The top graphic highlights all ESG risks. The bottom graphic shows more detail on the carbon risk in the portfolio.

ENVIRONMENTAL RISK

	Portfolio	Benchmark	Active
Carbon Risk (T CO2E/$M SALES)	126	296	-57.5%
Fossil Fuel Reserves (%)	3.7%	6.2%	-2.5%
High Impact Fossil Fuel Reserves (%)	3.4%	5.1%	-1.8%
Exposure to High Water Risk (%)	8.4%	10.5%	-2.1%
Freshwater Withdrawal Intensity (m3/$M SALES)	8,604	54,596	-84.2%
Total Water Withdrawal Intensity (m3/$M SALES)	13,765	220,977	-93.8%
Freshwater Withdrawal Coverage (%)	32.2%	36.8%	-4.6%
Total Water Withdrawal Coverage (%)	44.4%	54.2%	-9.9%

REPUTATIONAL RISK

(Very Severe Controversy Exposure)

	Portfolio	Benchmark	Active
Overall Reputation Risk (%)	0.2%	0.7%	-0.6%
Environmental (%)	0.0%	0.1%	-0.1%
Customer (%)	0.0%	0.1%	-0.1%
Human Rights (%)	0.2%	0.3%	-0.1%
Labor (%)	0.0%	0.4%	-0.4%
Governance (%)	0.0%	0.0%	0.0%

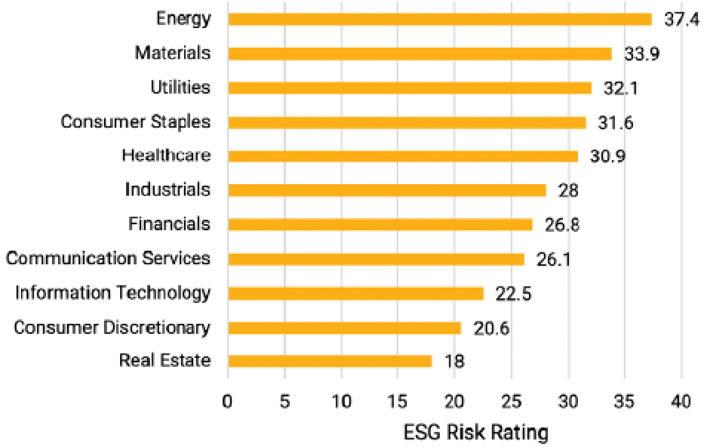
GOVERNANCE RISK

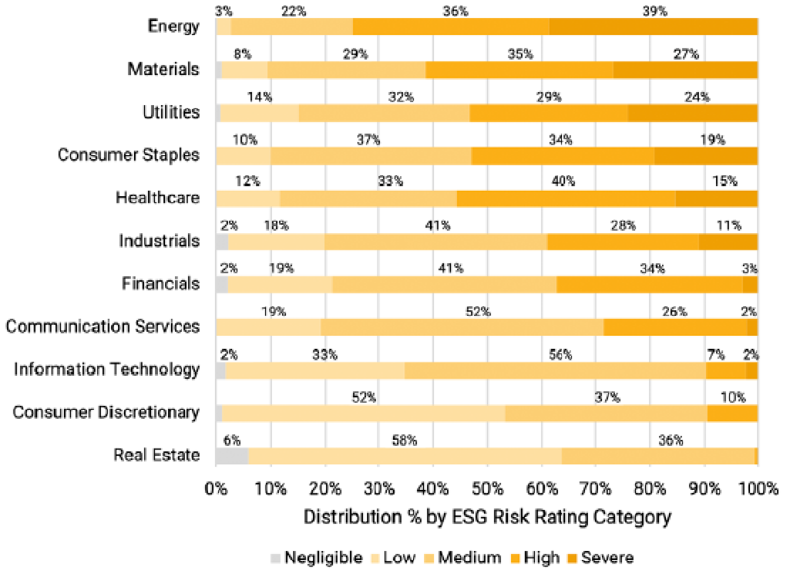
	Portfolio	Benchmark	Active
Governance Leaders (%)	33.6%	29.7%	3.9%
Governance Laggards (%)	9.7%	21.4%	-11.7%
Board Flag (%)	7.4%	19.7%	-12.4%
Lack of Independent Board (%)	8.3%	24.2%	-15.9%
No Female Directors (%)	0.8%	6.4%	-5.5%
Female Rep. 30% of Directors (%)	66.0%	46.1%	19.9%
Accounting Flag (%)	17.1%	13.5%	3.5%
Pay Flag (%)	5.5%	18.1%	-12.6%
Ownership & Control Flag (%)	13.9%	20.9%	-7.0%

		Portfolio	Coverage	Benchmark	Coverage	Active
Allocation Base	Market Cap					
Carbon Emissions tons CO2e / $M invested Investor Allocation: Market Cap	Scope 1+2	77.1	99.9%	102.3	99.6%	-24.7%
	Scope 3 – upstream	137.3	99.9%	149.1	99.6%	-7.9%
	Scope 3 – downstream	261.1	99.9%	403.0	99.6%	-35.2%
Total Carbon Emissions tons CO2e Investor Allocation: Market Cap	Scope 1+2	770.8	99.9%	1,023.4	99.6%	-24.7%
	Scope 3 – upstream	1,373.1	99.9%	1,491.3	99.6%	-7.9%
	Scope 3 – downstream	2,611.4	99.9%	4,029.6	99.6%	-35.2%
Carbon Intensity tons CO2e / $M sales Investor Allocation: Market Cap	Scope 1+2	162.5	99.9%	193.7	99.6%	-16.1%
	Scope 3 – upstream	289.6	99.9%	282.3	99.6%	2.6%
	Scope 3 – downstream	550.8	99.9%	762.8	99.6%	-27.8%

Source: MSCI

RISK EXPOSURE BY SECTOR - SUSTAINALYTICS





Sustainalytics assigns risk ratings to every sector. Based on Sustainalytics ratings, the average energy sector company is more than double the risk of the average Real Estate company. Sustainalytics ranks more of the Energy sector's ESG risk severe than other industries. Information Technology and Consumer Discretionary have some of the lowest risk ratings.

ESG risk ratings are comprised of Exposure and Management risk, which accesses how much unmanaged ESG risk a company is exposed to. The ratings measure the degree to which a company's economic value (enterprise value) is a at risk driven by ESG factors.

Source: Sustainalytics, Morningstar, Data as of September 7. 2022

CASE FOR ESG

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BENEFITS OF ESG

NYU did a meta-analysis of more than 1,000 academic studies published between 2015 and 2020, looking at the correlation between corporate financial performance and sustainability or ESG investing financial performance. NYU found that 58% of the studies found a positive correlation between corporate financial performance and sustainability. Only 8% found a negative correlation. Key takeaways:

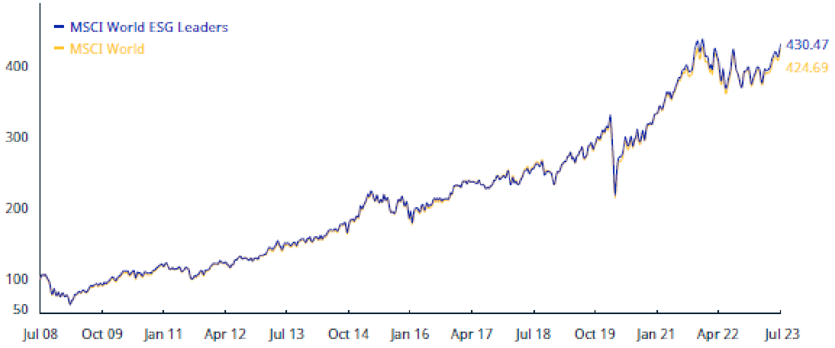
- Improved financial performance due to ESG becomes more noticeable over longer time horizons.
- ESG integration as an investment strategy performs better than negative screening approaches.
- ESG investing provides downside protection especially during a social or economic crisis.
- Sustainability initiatives at corporations appear to drive better financial performance due to mediating factors such as improved risk management and more innovation.
- Managing for a low carbon future improves financial performance.
- ESG disclosure without an accompanying strategy does not drive financial performance.

Source: October 2, 2021, NYU Stern, ESG and Financial Performance

PERFORMANCE

MSCI World Leaders Index is a market capitalization weighted index designed to represent the performance of companies that are selected from the MSCI World Index based on Environmental, Social, and Governance criteria (ESG ratings and exposure to ESG controversies).

CUMULATIVE INDEX PERFORMANCE – NET RETURNS (EUR) (JUL 2008 – JUL 2023)



ANNUAL PERFORMANCE (%)

Year	MSCI World ESG Leaders	MSCI World
2022	-14.30	-12.78
2021	34.17	31.07
2020	5.78	6.33
2019	30.51	30.02
2018	-3.12	-4.11
2017	6.26	7.51
2016	10.46	10.73
2015	10.16	10.42
2014	19.43	19.50
2013	22.05	21.20
2012	12.72	14.05
2011	-2.26	-2.38
2010	18.36	19.53
2009	28.30	25.94

INDEX PERFORMANCE – NET RETURNS (%) (JUL 31, 2023)

					ANNUALIZED			
	1 Mo	3 Mo	1 Yr	YTD	3 Yr	5 Yr	10 Yr	Since Sep 28, 2007
MSCI World ESG Leaders	2.20	8.72	4.89	15.69	14.47	10.90	11.32	7.88
MSCI World	2.28	8.66	4.95	15.15	14.30	10.42	11.36	7.81

FUNDAMENTALS (JUL 31, 2023)

	Div Yld (%)	P/E	P/E Fwd	P/BV
MSCI World ESG Leaders	1.90	22.22	18.66	3.60
MSCI World	1.96	20.75	17.51	3.07

INDEX RISK AND RETURN CHARACTERISTICS (SEP 28, 2007 – JUL 31, 2023)

				ANNUALIZED STD DEV (%) 2			SHARPE RATIO 2, 3				MAXIMUM DRAWDOWN	
	Beta	Tracking Error (%)	Turnover (%) 1	3 Yr	5 Yr	10 Yr	3 Yr	5 Yr	10 Yr	Since Sep 28, 2007	(%)	Period YYYY-MM-DD
MSCI World ESG Leaders	0.99	1.29	12.91	15.11	16.05	13.32	0.96	0.73	0.88	0.58	52.71	2007-10-09—2009-03-09
MSCI World	1.00	0.00	2.15	14.85	16.17	13.44	0.96	0.70	0.88	0.57	52.52	2007-10-09—2009-03-09

[1] Last 12 months [2] Based on monthly net returns data [3] Based on EMMI EURIBOR 1M from Sep 1 2021 & on ICE LIBOR 1M prior that date

Source: MSCI

CASE FOR MANAGING ESG RISKS

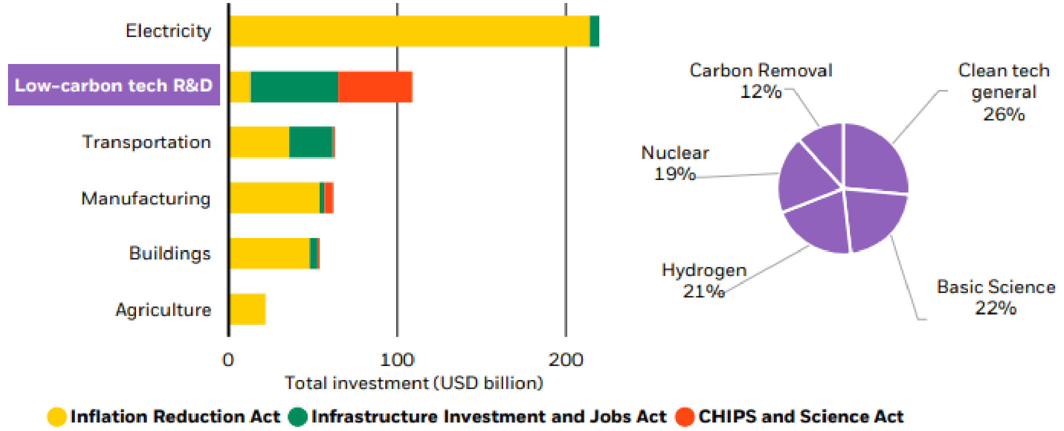
The growing impact of climate issues, income inequality, and scarcity of resources will drive the transition to a low carbon economy and demand greater investment of capital, creating financial and social return opportunities.

LOW CARBON TRANSITION CATEGORY	LOW CARBON TRANSITION RISK/OPPORTUNITY
Asset Stranding	Potential to experience stranding of physical or natural assets due to regulatory, market, and technological forces arising from “low-carbon” transition.
Product Transition	Reduced demand for carbon intensive products and services. Winners and losers are defined by the ability to shift product portfolio to low carbon products.
Operational Transition	Increased operational and capital costs due to carbon taxes and investment in carbon emissions mitigation measures leading to lower profitability
Neutral	Limited exposure to low carbon transition risk. Companies could face physical risk or indirect exposure to transition risk via lending, investment operations.
Solutions	Potential to benefit through the growth of low carbon products and services.

Sources: Bloomberg, MSCI

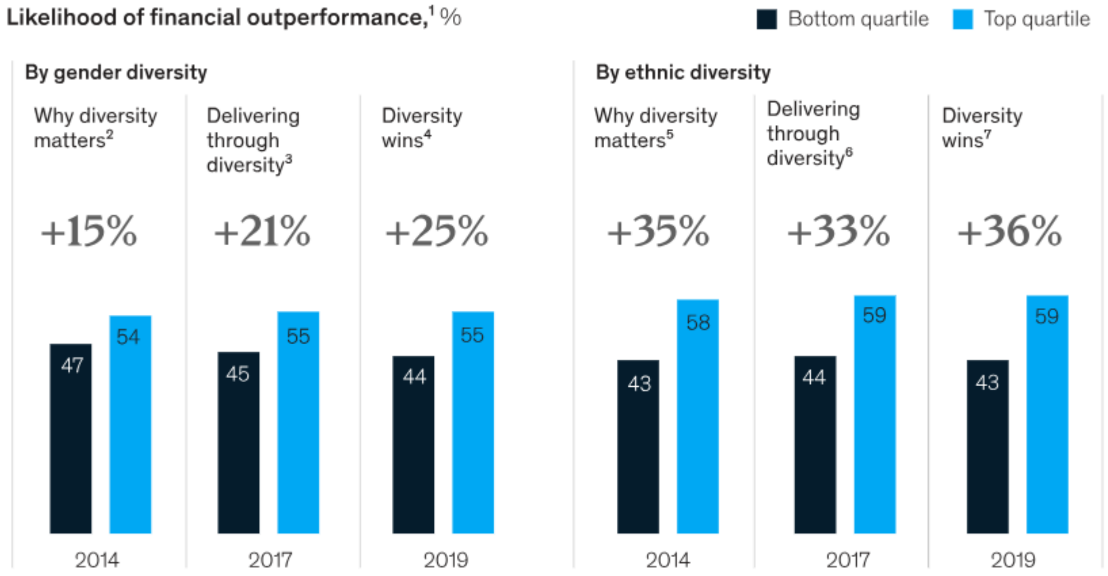
Significant public spending

Breakdown of public investment in this year's major climate-related U.S. legislation, December 2022



Source: BlackRock Investment Institute and Rocky Mountain Institute, December 2022. Notes: The chart shows a breakdown of estimated investment and incentives in this year's major U.S. legislation that had climate-related elements – the Inflation Reduction Act, the Infrastructure Investment and Jobs Act and the CHIPS and Science Act – as estimated by RMI (see https://rmi.org/climate-innovation-investment-and-industrial-policy) The analysis should be considered approximate and may be updated or refined by subsequent analysis.

CASE FOR DIVERSITY, EQUITY, AND INCLUSION



[1]Likelihood of financial outperformance vs the national industry median; p-value <0.05, except 2014 data where p-value <0.1. [2]n = 383; Latin America, UK, and US; earnings before interest and taxes (EBIT) margin 2010–13. [3]n = 991; Australia, Brazil, France, Germany, India, Japan, Mexico, Nigeria, Singapore, South Africa, UK, and US ; EBIT margin 2011–15. [4]n = 1,039; 2017 companies for which gender data available in 2019, plus Denmark, Norway, and Sweden; EBIT margin 2014–18. [5]n = 364; Latin America, UK, and US; EBIT margin 2010–13. [6]n = 589; Brazil, Mexico, Singapore, South Africa, UK, and US; EBIT margin 2011–15. [7]n = 533; Brazil, Mexico, Nigeria, Singapore, South Africa, UK, and US, where ethnicity data available in 2019; EBIT margin 2014–18.
Source: Diversity Wins data set

Economic Opportunity

- Likelihood of outperformance for diverse teams is +36%
- Diverse private equity funds outperformed in 78% of the vintage years studied
- Closing the racial wealth gap could add $1trillion by 2028

Access to Capital

- Diverse Managers control 1.3% of the investment industry’s $69 trillion
- Diverse investment managers more likely to invest in diverse communities
- Less than 10% of US portfolio managers at mutual funds and ETFs are women

Sources: McKinsey, Harvard, Knight Foundation

CONSIDERATIONS

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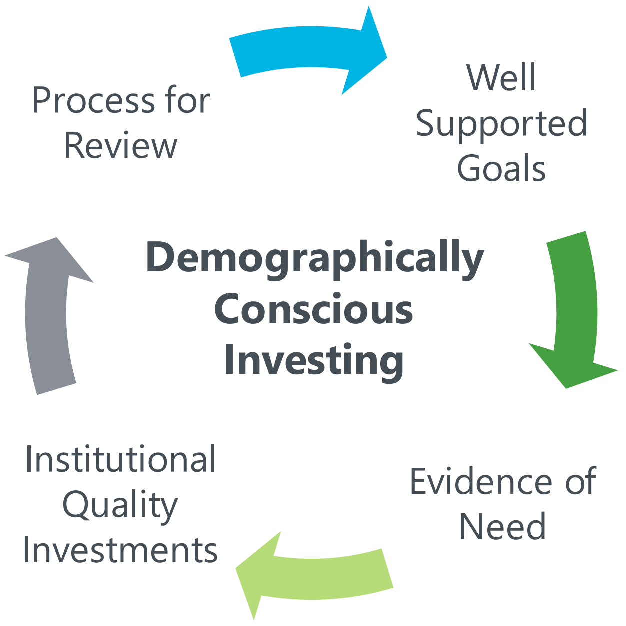
CONSIDERATIONS

- Provide discrete, well-supported, goals for demographically conscious policies.
- Identify qualitative and quantitative evidence demonstrating both past and current discrimination, e.g., redlining in or refusal to offer services based on protected categories, and the continued need for initiatives.
- Outline process for ongoing review, e.g., review the evidence annually to determine whether there is a continued need for the policies.
- Demonstrate that while mission alignment is a priority, quality; and performance are equally important.



Source: August 24, 2023, Draft guidance Lee Schwalb, Counsel for Growth

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