Sustainable Investment Products and Due Diligence

INSIGHTS FROM INDUSTRY EXPERTS

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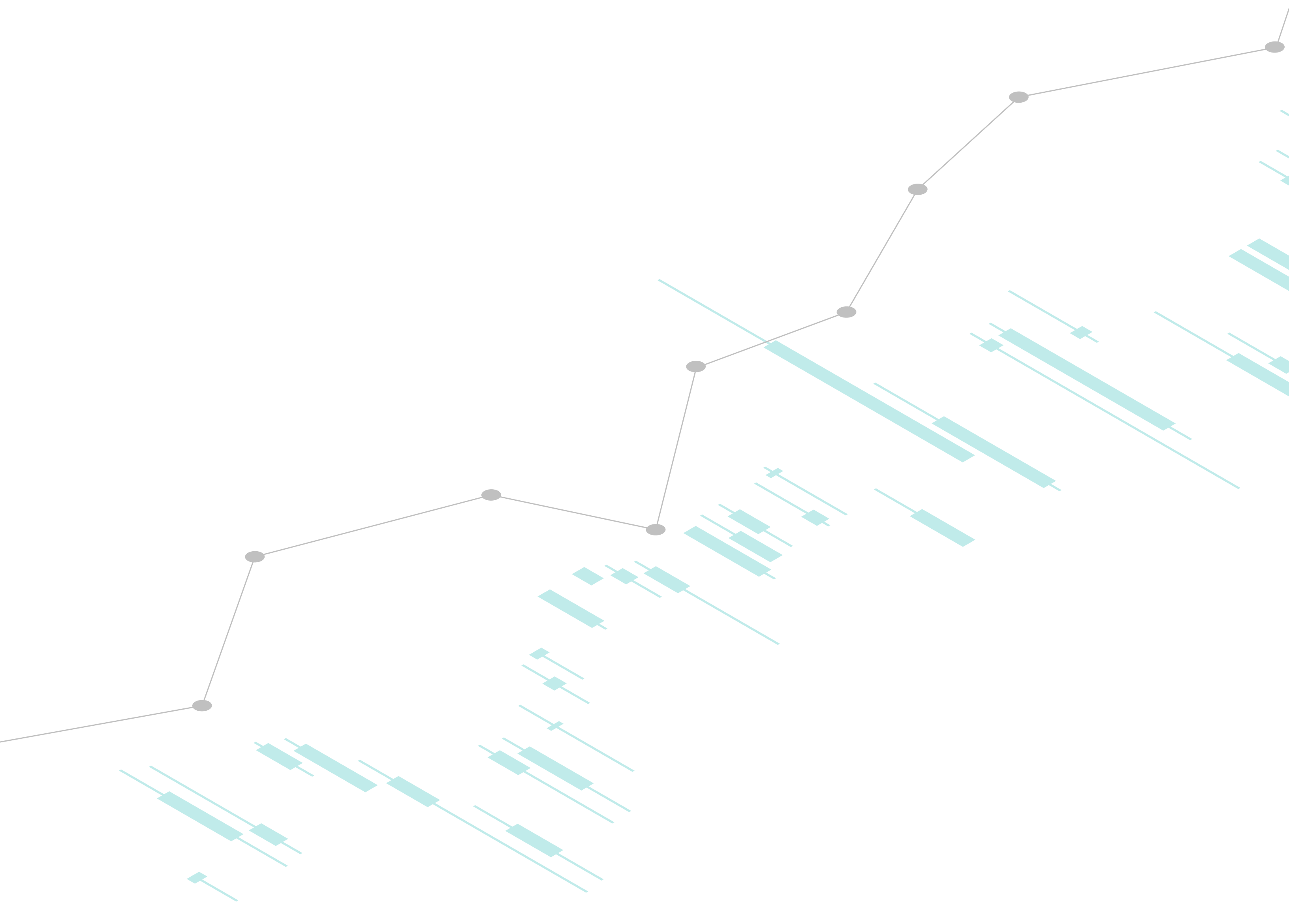
Thornburg
INVESTMENT MANAGEMENT



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Welcome

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More than a quarter of assets under management (AUM) worldwide are invested in "sustainable" strategies, and investors—both individual and institutional and at all wealth levels—are increasingly interested in integrating these strategies into their financial plans and investment portfolios.

In response, many asset managers are expanding their sustainability-related services to grow their businesses. These managers are developing various sustainability strategies and associated services and increasingly participating in related industry activities.

All this activity is welcome and needed. But as asset managers get more and more involved in sustainable investing, due diligence officers, financial consultants, investment staffs, fund trustees, and others must ask themselves: *Which managers are doing the best job providing sustainable investment services, whose approach is the most effective, and who provides the best fit for their needs?*

This report, *Sustainable Investment Products and Due Diligence,* is designed to prompt further dialogue on the nature and types of sustainability products on the market and to identify questions that arise in assessing their quality and success. Developed by The Investment Integration Project (TIIP) in partnership with the Money Management Institute (MMI) and with support from Thornburg Investment Management, it is intended to serve as a stepping stone along the pathway to the development of needed due diligence procedures for this growing investment discipline.

This report builds on the *Fundamentals of Sustainable Investment: A guide for financial advisors*, which was developed by MMI and TIIP to provide preliminarily answers to the *why, what*, and *how* of sustainable investment for financial advisors.

Since its release in the winter of 2019, *Fundamentals* has served as the basis for, or as a component of, several publications, educational events, and other curricula. We hope that this report similarly inspires other reports, events, and publications that carry the conversation forward.

As sustainable investment evolves, corresponding due diligence techniques will need to evolve too. We hope this report will help move that evolution forward.

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Summary

In response to growing investor interest in sustainable investing, asset managers have started to offer a wide range of products that incorporate sustainability or environmental, social, and governance (ESG) strategies.

There are various ways that investors and their due diligence officers can begin to distinguish among the increasingly-available sustainability-focused managers and products and identify those that align with their interests and goals. First, there are four primary types of sustainable investment managers. Each type of manager aligns with a different investor motivation for pursuing the practice, and each requires a different due diligence approach. They are:

1. **Financially-driven** managers that incorporate sustainability factors into security valuation and portfolio construction to mitigate related risks, pursue related rewards, and enhance value;

2. **Client-driven** managers that respond to client requests to create separate accounts that incorporate specific sustainability considerations;

3. **Manager-driven** managers that incorporate sustainability considerations into their products or services to attract clients with social and environmental interests; and

4. **Impact- or system change-driven** managers that pursue sustainability impact or system-change goals along with financial targets.

Second, there are a series of conventional manager due diligence considerations that usefully apply to investors' examinations of sustainable investment products and services with little need to modify their basic focus:

- **Intentionality:** the extent to which a manager deliberately produces intended outcomes or does so accidentally (the former being replicable and acceptable and the latter being haphazard and undesirable);

- **Philosophy:** the extent to which the manager explicitly and rigorously incorporates sustainable investment considerations into its philosophy (beliefs, policies) and indicates whether it applies these considerations to manage risk, engage with holdings, and/or avoid certain issues;

- **Process:** how clearly and purposefully the manager applies its philosophy in the capital markets to create an integrated and effective investment approach; and

- **People:** the extent to which sustainable investment staff are integrated into other business units (vs. operating in a silo) and their skills, proven competencies, background, and commitment.

And third, there are numerous ways that investors can compare the sustainable investment performance of prospective asset managers. Notably, conventional indices enable investors to examine the manager's financial performance vis-à-vis widely-accepted financial yardsticks, while sustainability indexes enable them to compare managers to a sustainability-focused benchmark. Analyses against both types of benchmarks can provide insight into how much of the performance difference between the strategy and the benchmark is attributable to sustainability policies. Investors might also compare the performance of sustainability funds in the same asset class and with the same strategy to peers, but should be particularly careful when doing so given the small number of sustainability-focused products in a given asset class and their different motivations, focus issues, and investment tactics.

These approaches to distinguishing and comparing managers provide investors with a useful starting point for conducting sustainability-focused due diligence. However, the investment industry must address investors' various unanswered questions about sustainable investment products and services (e.g. *How does due diligence differ by asset classes? How do officers rate a fund excelling in one area but failing in others?*) and develop standards for things like sustainability reporting on investments.

Introduction

This report is written for due diligence officers, financial consultants, investment staffs, and fund trustees seeking to identify who among the increasing number of asset managers offering financial products with claims to positive social and environmental impact and sustainability are doing a credible job.

It is intended as a discussion starter, an initial step on the road to a fully articulated framework for contending with this emerging and uncharted aspect of the due diligence discipline. It addresses issues unique to this aspect of due diligence, proposes a typology for differentiating between four different approaches to sustainable investment, introduces concepts related to systemic risks and rewards, and frames issues in need of further elaboration.

This report is an acknowledgement that sustainable investment is changing, and due diligence techniques will need to change with it. We hope this report will begin a conversation about what that evolution could look like.

Asset owners worldwide with their more than $17.5 trillion in assets under management—ranging from the largest pension and sovereign wealth funds to the smallest family offices and private individuals—increasingly allocate assets to investment products that incorporate sustainability or environmental, social, and governance (ESG) strategies. To serve this rapidly growing clientele, asset managers now offer a wide range of these products.

As such offerings proliferate, distinguishing among their sustainability-related performance is increasingly challenging. Asset owners selecting a sustainable investment manager want to know whose approach is most aligned with their concerns and to what degree sustainability factors in the investment process contribute to financial risk and return. Due diligence officers are tasked with assessing which managers are living up to their sustainability claims. Financial consultants and gatekeepers must distinguish between sustainability approaches while also finding equitable comparisons on financial and non-financial attributes.

> *What do managers mean when they call a product "sustainable"? How can due diligence officers, consultants, and asset owners distinguish which of the many "sustainable" products on the market are living up to their names? Who is doing a good job in this emerging discipline and who is not?*

Addressing these questions is critical to the advancement of sustainable investment. As market adoption rapidly increases, due diligence officers, financial consultants, and asset owners find themselves challenged to incorporate new perspectives and new metrics into their research processes in order to qualitatively and quantitatively examine these new strategies. Establishing a new foundation of important questions to ask, key performance indicators to examine, and an ability to determine comparability in approaches will help these stakeholders arrive at judgments on the quality of the rapidly growing number of products in the field.

A Convening to Identify Due Diligence Considerations

With support from Thornburg Investment Management, The Investment Integration Project (TIIP) launched the *Sustainable Investment Products and Due Diligence* project in early 2019 to further thinking and dialogue on how due diligence officers, asset owners, and gatekeepers can identify those asset managers who are doing the best job in integrating sustainability considerations into their products, policies, and practices. Early that year, TIIP hosted a half-day convening of industry experts in due diligence on sustainability products. They included representatives from asset owners and managers that use internally-developed or external sustainability products, financial consultants acting as gatekeepers for asset owners or managers seeking to identify high-quality sustainability products, and representatives from trade associations with increasing interest in such products.

In preparation for this meeting, TIIP commissioned Mark Sloss, CEO of Regenerative Investment Strategies, to prepare a background paper on the challenges of due diligence for sustainable investment products to provide a starting point for the day's discussion. Drawing on the insights from that discussion, the background paper, and its own insights into the challenges of integration of systemic environmental and societal risks into the investment process, TIIP then developed this report.

This Report

This report is designed to prompt further dialogue on the nature and types of sustainability products on the market and to identify questions that arise in assessing their quality and success. It is intended to serve as a stepping stone along the road to the elaboration of due diligence procedures for this emerging investment discipline.

The report helps establish best practices in three areas: types of sustainable investment products; major considerations raised by these products for the due diligence process; and the challenges that arise in rating and ranking them (see Table 1).

Table 1. Project Research Questions

TYPES OF SUSTAINABLE INVESTMENT PRODUCTS
• What are the types of sustainable investment products and how do they vary?
• How and why have these products evolved over time?
CONSIDERATIONS FOR SUSTAINABLE INVESTMENT DUE DILIGENCE
• What are the principal considerations in conducting due diligence and related evaluations of these products?
• How do these considerations differ from conventional due diligence assessments?
• How should due diligence officers, asset managers, and gatekeepers identify, evaluate, and monitor sustainable investment managers?
CHALLENGES FOR RATINGS AND RANKINGS
• What factors are useful in benchmarking, rating, or ranking these products?
• How might these factors be applied?

This report focuses primarily on due diligence regarding public equity sustainability products. Other asset classes not covered require additional consideration, although the basic principles discussed in this report apply. Section A provides a typology of sustainable investment products and services that aligns with investors' motivations for pursuing a sustainable investment approach. Section B discusses the cross-cutting considerations among the application of due diligence to sustainable investment products. Section C examines specialized due diligence considerations that can arise in relation to the various types of sustainable investment products and services. Section D outlines the challenges of benchmarking, rating, and ranking the sustainability aspects of these products. Appendix A provides a list of the select literature that TIIP reviewed as part of the project. Appendix B lists the roundtable participants.

NOTES ON TERMINOLOGY

This report uses the following terms in the following ways:

- *Sustainable investment* refers to the range of strategies used to create products to serve a multiplicity of clients. As used in this report, "sustainable" describes products frequently referred to as "ESG investing," "impact investing," "socially responsible investing," "best-in-class investing," and other variations on these themes.
- *Due diligence* refers to the analysis of the sustainability aspects of the products under consideration. It can refer to the specialized activities of formal due diligence officers and more broadly to the process by which asset owners and gatekeepers analyze the sustainability performance of fund managers.
- *Analyst* refers to those personnel conducting due diligence. To avoid confusion, we use "financial analyst" to refer to those who value investment securities.
- *Fund* includes mutual funds, separately managed accounts, in-house pooled funds, and similar investment vehicles.

A. Types of Sustainable Investment Products and Services

Convening participants shared knowledge and exchanged views on the various approaches taken by financial services firms in developing their sustainability products. These approaches have evolved in recent decades as the field has grown. Prior to 1970, certain faith-based organizations practiced a limited form of sustainable investment, shunning so-called "sin stocks"—those of companies involved in alcohol, gambling, tobacco, and military weapons production. Their underlying ethical motivation was "do no harm" while still profiting from investments.

Starting in the 1970s and 1980s, investors started to also consider matters of human dignity (human rights and apartheid, labor rights, diversity) and environmental and community justice (toxic waste and pollution, air and water quality), as well as community economic development and poverty alleviation. At that time, investors, primarily faith-based organizations, also started engaging with companies on these issues, urging improved practices, without necessarily taking a divestment approach.

In the 1990s and 2000s, three trends emerged. Investors with a focus on corporate governance increasingly stressed the financial benefits of incorporating ESG factors in security valuation. Second, investors placed greater emphasis on support for positive evaluation criteria. Finally, in the 2010s, investors became increasingly concerned with managing and measuring environmental and social impact in the context of their specific portfolios and of society more broadly.

Convening participants discussed approaches to due diligence for the somewhat confusing array of available sustainable investment products. These strategies reflect the range of investors' motivations for pursuing sustainable investment, and each requires a different due diligence approach. It is therefore useful to establish a typology for sustainable investment products and services that reflects investors' varied motivations for pursuing the approach. The typology is described below and summarized in Table 2.

Financially-driven. Managers that create funds for which sustainability factors are incorporated as a crucial part of security valuation and portfolio construction and therefore are presumed to add value through additional risk controls and the pursuit of opportunities for otherwise unrecognized rewards. For example, managers indicate in their policy statements that they believe sustainability considerations such as climate change are material to security selection and portfolio management. The managers' motivation is to enhance performance of their funds.

Client-driven. Managers that are asked by clients to create separate accounts that incorporate specific sustainability considerations. For example, clients may ask managers to create customized, separately managed accounts that do not invest in companies involved in the production of certain problematic products such as tobacco or landmines and cluster bombs. Clients' motivations for doing so are often rooted in the guiding principles of multi-generational families or the alignment of portfolio with purpose for charitable institutions. The managers' motivation here is to serve clients' specific sustainability-related requests, thereby either retaining existing clients or attracting new ones.

Manager-driven. Managers that define sustainability criteria for sustainability products, typically mutual funds, Exchange-Traded Funds (ETFs), pooled funds, or separately managed accounts. The managers provide the definition of the sustainability criteria and the policies and procedures for their incorporation. Sustainability issues are integrated into the products or services primarily for the social and environmental benefits they are presumed to realize for the client as well as society at large. For example, managers create funds that exclude certain industries, promote poverty alleviation, or specialize in engagement with companies on sustainability issues. The managers' motivation is to benefit society, while generating competitive returns, and to provide a diverse range of options. From the manager's perspective, this limited, but targeted, range of products provides their investors with the opportunity to be selective in choosing strategies that comport with their world view without requiring the manager to provide customized options.

Impact- or system change-driven. Managers that stress the value of creating direct, on-the-ground social and environmental impact or a shift in paradigms. They may do so through the selection of investments with specific social or environmental business models or the application of tools oriented toward influencing paradigms that produce undesirable outcomes. For example, impact and system-driven managers create products and adopt practices that seek to address the challenges of climate change. Impact and system change are measured differently from financial returns, requiring more qualitative metrics and longer time frames in a manager's reporting.

Table 2. Four Types of Sustainable Investment Products and Services

1. FINANCIALLY-DRIVEN
Enhanced financial performance is the presumed value of the sustainability policies and practices.
2. CLIENT-DRIVEN
Serve specific client needs. Customized accounts tailored to specific values as specified by the client.
3. MANAGER-DRIVEN
Attract clients to the various approaches to sustainable investment adopted by the manager.
4. IMPACT- OR SYSTEM CHANGE-DRIVEN
Attain sustainability impact or system-change goals along with financial targets set by the manager.

Managers may provide a combination of these four types of sustainable products or may offer different products, each with its own focus. This amalgamation of different approaches means that those conducting due diligence must be conversant with the particularities of each and be prepared to evaluate them along the full range of their stated goals and intentions.

The trillion-dollar Norwegian national pension fund is, for example, an asset owner incorporating policies with multiple motivations within a single overall strategy. It works with an ethics council that dictates certain exclusions based on internationally accepted norms and treaties; it incorporates into its financial risk disciplines material environmental and social concerns; and it actively engages with firms to improve their sustainability practices. Conversely, different managers can use a single tactic for differing reasons. A manager excluding coal companies from a portfolio, for example, may be doing so at a client's request, because of perceived financial risks, or because of the long-term risks that coal's contribution to climate change pose for all its investments.

For those assessing the nature and performance of sustainable investment products, this range of approaches can be initially daunting. Fortunately, many of the questions arising are a familiar part of traditional due diligence and do not require new skills or specialized knowledge. In addition, these basic questions cut across all sustainable investment products, simplifying the task further. Nevertheless, each approach to the creation of a sustainable investment product does pose specific challenges that must be considered in evaluations of managers and their products.

B. Conventional Due Diligence Considerations That Apply to Sustainable Investment

Convening participants discussed many of the due diligence factors that have arisen as sustainable investment has evolved in recent years. The pre-1970s conception of ethical investment (as it was then known) entailed product-related screens implemented independently from portfolio decision-making and has since been replaced by approaches that place sustainability factors on an even footing with traditional financial ratios, asset allocation decisions, management team assessments, and other tools common to conventional investment and hence to conventional due diligence. Today, in the course of due diligence assessments, the degree and effects of sustainability integration on portfolio construction and performance are intrinsic to the framework of philosophy, process, people, portfolio, and performance that are a familiar part of due diligence. Similarly, the question of the intentionality of the manager's methods is of overriding importance in both exercises.

The following conventional due diligence considerations apply to sustainable investment products and services with little need to modify their basic focus.

Intentionality

A well-crafted sustainability due diligence analysis distinguishes between processes that produce deliberate outcomes and those with accidental byproducts. Clearly, analysts prefer the former to the latter, but both are useful in forming assessments. In conventional due diligence, haphazardly-generated and unexplainable investment returns, volatility, concentration, or style are generally not creditable. Outcomes, positive or negative, are appraised and the manager's methods and processes are analyzed to determine the degree to which they arise from deliberate decision-making or result from biases that their teams may not themselves fully understand. It is difficult to deem a strategy "good" in either relative or absolute terms if it appears that the manager simply stumbled upon strong results. Analysts need to be convinced that results are explicable and reproducible—a principle that holds true for sustainable investment portfolios as well as those using only conventional approaches.

Specifically, the reason not to credit an accidental sustainable investment-related result is that no expectation exists that the manager or portfolio will continue to stay within the bounds of sustainability-related compliance. Strong sustainability performance needs to be tied back to particular aspects of the manager's processes explicitly designed to create and repeat such outcomes. The motivation for attaining such results may arise from an expression of sustainability values or a desire to enhance financial performance. In either case, it is the relationship between intent and outcome that is important.

Box 1. Assessing Intentionality

1. **Presence.** Does the manager intentionally integrate sustainability considerations into its analyses? Is its intentionality implicit/explicit? Is it stable and predictable?

2. **Qualities/quality.** How intense is the manager's intentionality? Does it amount to a casual incorporation of sustainability in some facets of the investment process, or is it a comprehensively and deliberately applied discipline? Does the manager apply sustainability considerations based on carefully-considered inputs, processes, and objectives or does it do so as a "box-checking exercise" without any clear motivation?

3. **Materiality.** Does the manager consider material sustainability factors in its analysis and decision-making? That is, does it consider sustainability factors that likely impact financial or non-financial performance?

Philosophy

Integration begins with, and is ultimately based on, the investor's philosophy. Consequently, it is crucial that managers be explicit about intentions. Those committed to sustainable investment will incorporate their considerations rigorously into the philosophy—or its close siblings, beliefs and policies—that drives their portfolio creation and related activities. They will clearly articulate the role sustainability consideration plays and indicate the benefits they hope to derive from this integration. This is where managers can clarify whether sustainability factors are used strictly as a risk tool, an issue avoidance tool, a positive change tool, an engagement and advocacy tool, or some combination of these factors. It is in the philosophy that the first expression of intentionality can be found. Absent its clear and concise framing in sustainability terms, analysts will be hard pressed to assess a manager's practices.

Process

Taking philosophy and applying it in the capital markets is where managers demonstrate their ability to create an integrated and effective sustainable investment approach. Each asset management firm will address integration in its own way, but the overriding question is what its specific sustainability considerations are and how the manager is implementing and accounting for them. To be consistent and effective, its process needs to be clearly articulated and responsibilities well-defined. Clarity of purpose and process is crucial, but one internal structure may not necessarily be better than another. In numerous instances, for example, a sustainable investment team is treated like a compliance function separate from investment decision-makers. This structure is neither good nor bad in and of itself, but it is material to whether a process is consistent with the manager's stated sustainable investment integration policies. It is not possible to gauge the quality of sustainability outcomes or their expected persistence without assurances that processes are designed with desired outcomes in mind.

People

As with any other aspect of a due diligence evaluation, analysts must examine a staff's skills, proven competencies, background, and commitment. If it is not clear who is responsible for the sustainable investment implementation process or if responsible staff are not part of compliance and investment decision-making, integration is unlikely to be effective or consistent. Analysts must therefore understand how and to what extent sustainability considerations are owned by key stakeholders within the firm, from research analysts to portfolio managers to top executives. In addition, they need to assess whether staff are properly trained and have adequate resources to do their jobs.

Performance

A common myth holds that employing sustainability considerations in portfolio management leads to financial underperformance. This belief is an extrapolation from purely exclusionary approaches that can produce concentrations and underrepresentation in industries or asset classes leading to uncompensated risks. A 2019 study by Morgan Stanley of nearly 11,000 mutual funds from 2004 to 2018 found that there is "no financial trade-off in the returns of sustainable funds compared to traditional funds, and they demonstrate lower downside risk."[1]

1 Institute for Sustainable Investment. Sustainable Reality: Analyzing Risk and Returns of Sustainable Funds. (New York: Morgan Stanley) 2019. Retrieved from https://www.frc.org.uk/getattachment/5aae591d-d9d3-4cf4-814a-d14e156a1d87/Stewardship-Code_Final2.pdf on November 12, 2019.

Although it cannot be said that sustainability integration equates with poor returns across the board, when analysts observe products with systematic underperformance, they should consider the factors that contributed to this underperformance and whether a sustainable investment process, inappropriately conceived or executed, is among them.

In addition, as in any due diligence evaluation, analysts will determine if the performance of the product or service has been appropriately and adequately reported. Sustainability performance poses particular challenges. See Section D.

Other Considerations

Proxy voting (i.e., for managers holding publicly-traded securities). The Securities and Exchange Commission considers the proxy an asset and requires disclosure of a manager's proxy voting guidelines and actual votes each year. Shareholder proposals addressing sustainability-related issues appear regularly on the proxies of the largest companies. A sustainable investment due diligence assessment should include assurance of the existence of positions on sustainability issues and votes consistent with those guidelines. In addition, analysts will want to assess whether these positions and votes are aligned with the manager's overall sustainability policies and practices.

Engagement. Active managers that build their processes around fundamental research and direct interaction with portfolio companies (plant visits, meetings with C-suite executives, evaluating supply chains) engage to the extent such interaction supports stock valuation disciplines. So called "activist" shareholders, including hedge funds and private equity firms, considerably deepen that engagement by fostering or even demanding changes in company business strategy and organizational structure to enhance profitability and stock price. Passive (index) managers may also engage on governance, as well as on social and environmental issues.

Sustainable investment managers engage with firms to improve their social and environmental practices with an eye to reducing risks, protecting brand reputation, or otherwise enhancing long-term firm value. Understanding and monitoring managers' engagement efforts should be part of a due diligence process. Concerns include the consistency of those efforts with overall sustainable investment policies and assessments of their efficiency and effectiveness.

Data. As is the case with financial data providers, a variety of sources for ESG data come with their own particular methods and interpretations. Several standards for ESG reporting have evolved over the years. The Sustainability Accounting Standards Board, for example, focuses on industry-specific materiality; the Global Reporting Initiative focuses on stakeholder relations. Aggregators of these data have developed differing methods for presenting and interpreting them. As a consequence, those conducting due diligence on sustainability funds will want to understand the data sources used and their implications. Among the major data sources are Bloomberg terminals, CDP (formerly Carbon Disclosure Project), Institutional Shareholder Services, Moody's (through its acquisition of Vigeo-EIRIS), MSCI, Standard & Poor's (through its acquisition of Trucost), Sustainalytics, and Truvalue Labs.

Cash reserves. Most managers hold cash reserves to manage their funds' inflows and outflows or as an asset allocation strategy. Sustainably-oriented liquidity products are not comprehensively available or employed, but analysts will want to examine whether such reserves conform to sustainable investment guidelines for the strategy. Similarly, derivatives used for hedging or performance alignment purposes should be evaluated for consistency with managers' guidelines.

The questions outlined in Table 3 are ones that a due diligence officer might ask when assessing a sustainable investment product. They apply to all sustainability products, whatever their motivation or issues of concern.

Table 3. Cross-Cutting Considerations

1. INTENTIONALITY

- Do the product's sustainability results come from intentional policy and practice with regard to sustainability considerations? Are they by design, or are they an accidental result of other policies and practices?
- Are the results likely to be consistent going forward?
- Does the manager clearly state its intentions regarding sustainability criteria, policies, and practices?

2. PHILOSOPHY

- Is the manager's philosophy on sustainability incorporated into its Investment Policy Statement? Investment Belief Statement?
- Does the manager relate its philosophy to its obligation to generate benefits for its clients or beneficiaries? If so, is the nature of that benefit clearly described?
- Are the practical steps for implementation of the philosophy memorialized in guidelines that are clear and can be easily implemented by those responsible?
- Is the fund's philosophy thoroughly implemented in practice?

3. PROCESS

- Does the manager clearly articulate the process by which it intends to implement its sustainability-related philosophy?
- What institutional mechanisms are in place to assure implementation and integration of that process?
- Are the roles and responsibilities of those integrating the sustainability policies clearly defined?
- Does a separate team or department have those responsibilities, or are they folded into the job descriptions of all in the firm?
- Is the compliance function fully informed of and integrated into the sustainable investment processes?
- To whom do those responsible for sustainability integration report? How often? In what form? With what content?
- Who is responsible for proxy voting and engagement and reporting on these activities?

4. PEOPLE

- Are those with sustainable investment-related responsibilities fully trained in their responsibilities? Is that training ongoing?
- What are the qualifications of those holding those positions?
- What sustainable investment-related resources do they have at their disposal? Are those resources adequate to the job?
- Are sustainable investment-related goals and benchmarks built into their compensation incentive structures?

5. PERFORMANCE

- Is the influence of sustainability factors accounted for in performance attribution?
- Does the manager report on the sustainability characteristics of the portfolio? On the social and environmental "returns" associated with the fund or the manager's related activities?
- Does the manager claim sustainability impact from the portfolio? If so, does it measure and report on that impact? Is that sustainability reporting integrated with financial reporting?
- Do the manager's proxy voting guidelines clearly state its positions on sustainable investment-related resolutions likely to appear on the proxy statement?
- Does the manager report adequately on its voting on sustainability-related proxy resolutions? On its engagement initiatives and related activities?

C. Due Diligence Considerations by Type of Sustainable Investment Product

This section outlines the due diligence considerations specific to each of the four types of products outlined in Section A. For each product type, managers have effectively made certain claims or implicit promises to their clients, which deserve careful evaluation. This section describes the claims made and the considerations raised by these claims. As noted earlier, these motivations often overlap in various ways for specific products. Due diligence evaluations will therefore need to account for a variety of issues raised by the specific multiple, overlapping claims implied.

Financially-Driven

The managers of most sustainability funds state that they believe that sustainability considerations can, at least in certain circumstances, add value to their security selection. They should therefore systematically incorporate sustainability data into their valuations and track its effects in performance attribution analyses.

Clients and due diligence assessors are entitled to know why and when the manager believes sustainability factors are material. Performance attribution reporting should treat sustainability factors like any others, indicating when they have been positive, negative, or neutral. If the manager claims that sustainability factors add value occasionally or consistently, that value should show up in performance and the manager should be able to identify when it has done so.

Box 2. Due Diligence Considerations for Financially-Driven Products

- Does the manager explain adequately why it considers sustainability to be material?
- Are sustainability factors integrated throughout the fund's investment discipline?
- Are sustainability factors included in the fund's performance attribution analyses? Are these analyses included in the fund's reporting to clients?
- Does the manager incorporate material sustainability factors across all its products or only those specifically designated as "sustainable"? If not, why not?

Client-Driven

For client-driven sustainability products, managers in effect are promising that their compliance procedures can handle the intricacies of customized accounts based on their clients' sustainability concerns. They believe they can comply with the clients' specific requirements regarding sustainability factors. In addition, if they believe they have limitations in their ability to do so, they have an obligation to discuss those limitations with their clients, explain why they exist, and obtain their clients' permission to operate within those limitations.

These compliance tasks are often complicated by a client's challenges in fully articulating the parameters of their sustainability concerns. For public equities, for example, a client wishing to avoid companies involved in certain businesses or entire industries should provide a list of those securities or a clear definition of those industries. Often, however, clients approach managers with only a vague sense of what sustainability considerations they want to incorporate. They may say, "I don't want companies like X in my portfolio," or "I do not want to invest in companies in Y industry or be involved in controversies relating to Z issue." In these cases, the manager and client will need to develop mutually agreed-upon definitions supplemented by specific lists. Inevitably, borderline cases will arise, and a mechanism needs to be in place to communicate with the client on how to handle them.

Moreover, clients may request the incorporation of sustainability considerations that a) are so strict they will moderately impact the risk-adjusted performance of the fund, or b) may be impractical to implement—that is, the data necessary for their implementation is not available or the investment universe that would remain as a consequence of their implementation is so restricted that it is effectively uninvestable. In the former case, the manager has an obligation to inform the client of the likely impact on the fund's performance. In the latter case, the manager must simply forgo the opportunity to accept the particular mandate.

Finally, unless otherwise specified, the manager is responsible for tracking developments with regards to the client's sustainability concerns and needs to monitor any with implications for the client's portfolio.

Box 3. Due Diligence Considerations for Client-Driven Products

- Are the client's sustainability concerns clearly articulated and communicated to the manager?
- Have the client and manager clearly defined the parameters of the mandate? Is the mandate memorialized in written form?
- Are communications systems in place in case ambiguous situations arise regarding the mandate?
- Have any material financial risks or other implications of the mandate been communicated to the client?
- Do the manager's processes ensure compliance with these mandates?
- Does the manager regularly monitor accounts for compliance?
- Does the manager keep up to date on developments relating to the sustainability issues of concern to the client? Does the manager have in place systems to implement any necessary changes in portfolios in a timely manner?

Manager-Driven

For manager-driven funds, the manager is responsible for defining the parameters of the fund's sustainability criteria and its implementation processes for those criteria. Different managers will adopt different approaches for various funds—some using negative criteria, others positive, some coupling security selection with engagement with their issuers' social and environmental policies or practices, and others not. In addition, each manager will emphasize different issues in varying degrees. Whatever the particulars, it is the manager's obligation to define clearly its intended approach and issues of concern, implement those intentions consistently and thoroughly, be prepared to answer questions and otherwise communicate with clients about that implementation, and report on its success in attaining goals it may have set as part of its policies.

Box 4. Due Diligence Considerations for Manager-Driven Products

- Has the manager clearly communicated to current and potential clients the sustainability-related motivations and intentions behind the product?
- Does the manager have procedures in place for ongoing communications with its clients and resources allocated to responding to any questions from clients that may arise?
- Does the manager consistently conduct its security selection and portfolio construction in line with its sustainability-related public statements and communications with its clients?
- Does the manager define, track, and report on the impact on society and the environment of its sustainability practices?

Impact- or System-Change Driven

Managers self-identifying as impact investors or stating that they are seeking to address and manage their systemic risks and rewards have in effect made claims that not only are they addressing social and environmental issues of broad concern, but that they can and do have positive impact in their particular areas of focus. They therefore have an obligation to communicate clearly what areas they are seeking to impact or change, their goals for such change, and their strategies for achieving that impact.

Box 5. Due Diligence Considerations for Impact- or System-Driven Products

- Has the manager set specific impact or system-level goals? Has it set timelines for attainment of those goals?
- Has the manager justified why it has chosen those particular goals?
- Does the manager articulate what tradeoffs exist and are or are not acceptable in pursuit of impact outcomes where portfolio risk and return are concerned?
- Does the manager have a strategic plan for attaining those goals? Are those plans practical and reasonably attainable?
- Does the manager measure its progress relative to its goals? Using reasonable metrics? Does the manager report out publicly and adequately on that progress?
- Is the manager making progress toward its goals? If so, has the manager done so efficiently?

D. Benchmarking, Comparative Rating, and Reporting

Benchmarking and Peer Group Analysis

Numerous sustainability indexes are available that enable investors to compare the performance of their strategies to a sustainability-focused benchmark. Such benchmarks can be used to assess the manager's success in incorporating sustainability considerations of one sort or another into its portfolios.

Benchmarking sustainability strategies to conventional indices is also useful in assessing the manager's relative financial performance vis-à-vis widely-accepted financial yardsticks. Analyses against both sustainability and conventional benchmarks can provide insight into how much of the difference between the strategy and the benchmark is attributable to sustainability policies.

The argument against using sustainability indices as benchmarks for performance comparisons is that starting with these indices ignores concerns for underperformance of a fund due to sustainability policies relative to traditional benchmarks. Since this comparison is between a sustainability strategy and an index constructed using sustainability considerations, there is no basis for understanding how sustainability policies affect performance relative to traditional benchmarks. When considering relative performance, most investors today expect that measurement to be made in relation to the performance of those conventional benchmarks. Comparison of the financial performance of a sustainability fund versus a sustainability index also helps in assessing the value added by the manager given its investment universe.

Comparative Rating

Like conventional funds, the performance of sustainability funds in the same asset class and with the same strategy should ideally be compared to that of their peers, although adding sustainability factors to like-to-like comparisons complicates the task.

To begin with, there is substantial variation among the motivations and issues of concern among sustainability managers, not to mention their approaches to security selection, engagement, and proxy voting. In addition, some managers actively pursue sustainable investment-related activities collectively with their peers to increase their influence, while others are active in public policy initiatives relating to sustainability issues, and still others take leadership positions in the field and have contributed disproportionately to its development. Comparisons among these different activities can be difficult.

Further complicating the situation is the fact that, although the number of sustainable investment products has rapidly expanded in recent years, it is by no means as large as that of traditional financial products.

In short, the variations in focus and tactics, combined with the limited number of sustainable investment products in any given asset class, currently make meaningful peer-to-peer comparisons difficult in the extreme.

That said, it is still possible to make qualitative comparisons among product providers. Among the factors to be considered favorably, in addition to financial performance, are:

- Rigor and thoroughness in implementation of policies;
- Innovation in sustainability product development;
- Identifiable, measurable, positive product-driven social and environmental impacts;
- Leadership in the building of the field;

- Clarity and accessibility in communications and reporting; and
- Demonstrable effectiveness in improving sustainability practice among corporations and investment peers.

Reporting

Evaluations of reporting on sustainability factors can take many forms. These might include:

- Clarity on the manager's underlying motivations and principles;
- Degree of successful integration of the manager's sustainability and financial reporting;
- Balance of quantitative statistics with qualitative analyses and explanation of difficult-to-make judgments;
- Credible justifications for the choice of social and environmental issues on which to focus;
- Identification of short- and long-term goals, both related to sustainability and returns; and
- Implementation and scope of communications on sustainability policies, strategies, and outcomes.

Conclusion

As due diligence officers, financial consultants, investment staffs, and fund trustees approach the task of evaluating managers' performance on the social and environmental challenges of sustainable investment, they will run across difficult decisions, complications, and dilemmas.

For example, how does due diligence differ by asset class? How do officers rate a fund excelling in one area but failing in others? How do they handle a diversified financial firm with funds that score well on sustainability factors, but that at the same time participates in financial transactions that undercut those social and environmental goals?

Without broadly agreed upon standards for the various aspects of sustainability reporting on investments, how should investors compare the quality of reports that take substantially different approaches? How do they assess the sustainability impact of individual managers who claim to address large-scale systemic risks such as climate change or income inequality when progress in those areas takes time and requires collaborative efforts?

Answering these questions and others with similar concerns is beyond the scope of this discussion paper. As the field evolves, however, investors can look forward to case studies, best practices, reporting standards, sustainability benchmarks, and related resources, as well as training programs to increase skills and sophistication in this area. As investment evolves to taking greater responsibility for its social and environmental impacts, so will the processes of due diligence evaluation.

Acknowledgements, Disclaimer, About TIIP and MMI

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About TIIP and MMI

TIIP. The Investment Integration Project's (TIIP) mission is to help investors understand the feedback loops between their investments and the planet's overarching systems—be they environmental, societal or financial—that make profitable investment opportunities possible. TIIP provides these investors with the research, analysis, and guidance to manage the impacts of their investment policies and practices on these systems.

MMI. The Money Management Institute (MMI) is the industry association representing financial services firms that provide financial advice and investment advisory solutions to investors. Through conferences, educational resources, and thought leadership, MMI facilitates peer-to-peer connections, fosters industry knowledge and professionalism, and supports the development of the next generation of industry leadership. MMI provides to its members industry research and analysis, white papers on emerging trends, and interviews with industry thought leaders.

APPENDICES

APPENDIX A: Additional Resources

TITLE	AUTHOR	YEAR	HIGHLIGHTS
Telling Their Value-Creating Stories: Why Asset Owners Should Use the Integrated Reporting Framework	Keith Ambachtsheer	2019	Outlines how asset owners (AOs) can adopt (and adapt) the Integrated Reporting Framework (<IR> Framework) developed by the International Integrated Reporting Council (IIRC) in 2013 to promote corporations' communication about value creation.
ESG Integration in the Americas: Markets, Practices, and Data	CFA Institute and Principles for Responsible Investment (PRI)	2018	Suggests a three-pronged ESG Integration Framework that investors can use to examine and identify the ESG integration techniques that are right for them.
Hiring an Investment Consultant: Making Your ESG Intention Actionable	Intentional Endowments Network	2018	Helps investors with selecting the right investment consultant to help them fulfill their ESG investment goals, one with a strong conviction for ESG integration and that understands the long-term impact of the practice on risks and returns.
Building Power Across the Impact Investment Field: Key Takeaways from Our Investment Advisor Search	Jessie Smith Noyes Foundation	2018	Describes Noyes' process for selecting a new advisor and summarizes lessons learned for peer organizations similarly looking to align their investments with their missions and to catalyze systemic change.
Aligning Expectations: Guidance for Asset Owners on Incorporating ESG Factors into Manager Selection, Appointment and Monitoring	Principles for Responsible Investment (PRI)	2013	Provides asset owners (AOs) with a roadmap for identifying, selecting, and managing investment managers (IMs) that integrate environmental, social, and governance (ESG) factors into investment analyses.
A Practical Guide to ESG Integration for Equity Investing	Principles for Responsible Investment (PRI)	2016	Describes ESG manager selection as having three phases: selection, appointment, and monitoring. It notes that the most effective ESG managers are those that systematically integrate it across all processes and tools.
Adding Sustainable and Responsible Investing Options to Defined Contribution Plans: A Resource Guide for Plan Sponsors	US SIF	2017	Guides plan sponsors in incorporating SRI into their plans and executing necessary manager due diligence processes.
Moving Forward with Sustainable, Responsible and Impact Investing: A Roadmap for Money Managers	US SIF	2018	Summarizes best practices for sustainable, responsible, and impact investing for managers who are looking to launch or grow their SRI programs and practices.

Note: In addition to the reports outlined in this attachment, investors can also find guidance about ESG manager selection from two online resources developed by the Global Impact Investing Network: (1) A Guide for Impact Investment Fund Managers: A Step-By-Step Resource to Creating and Managing a Private Equity Impact Fund. Conducting Due Diligence, and (2) Impact Toolkit.

APPENDIX B: Project Roundtable Participants

Alex Bernhardt, Principal, US Head of Responsible Investment, Mercer Investment Consulting

William Burckart, President, TIIP

Jon Hale, Head of Sustainable Investing, Morningstar

Sarah Hoyt, Investment Director, Mission Related Investing, Cambridge Associates LLC

Eric C. Hsueh, Director, Investment Manager Research, Cornerstone Capital Group

Carole Laible, CEO, Domini Impact Investments*

Steve Lydenberg, CEO, TIIP

Jessica Matthews, Managing Director, Head of Sustainable Investing, JP Morgan

Craig Pfeiffer, President and CEO, Money Management Institute

Mark Sloss, CEO, Regenerative Investment Strategies

Anna Snider, Head of Due Diligence, Global Wealth & Investment Management CIO Office, Bank of America

Kevin Sullivan, Team Lead, Global Manager Research, Wells Fargo Investment Institute

Lily Trager, Executive Director, Investing with Impact, Morgan Stanley Wealth Management

Brett Wayman, VP, Impact Investing, Envestnet

*Roundtable host

Sustainable Investment Products and Due Diligence

INSIGHTS FROM INDUSTRY EXPERTS

Steve Lydenberg, William Burckart and Jessica Ziegler, with Mark Sloss

Want to learn more about sustainable investment and how it can be incorporated with traditional advisory approaches and practices? The **MMI/Morningstar Sustainable Investing Curriculum** is an eight-course online curriculum based on 70 hours of interviews with subject matter experts and information from 180 unique sources. Contact MMI at **(646) 868-8500** or **learning@mminst.org** for more information and a demonstration.

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