ENVESTNET®

THE
Envestnet Edge
INSIGHTS FROM ENVESTNET | PMC

OCTOBER 2014

You Know What's Not Sustainable? Ignoring the Opportunity in Impact Investing

Markets may be convulsed with volatility, but paying attention to long-term trends remains important. Advisors may want to consider the expanding universe of impact investing.

Zachary Karabell
Head of Global Strategy
Envestnet, Inc.

Faced with the daily noise of markets ebbs and flows (and of late, that news has been coming in at a fast and furious clip), it's easy to overlook the deeper trends. Yes, a series of geopolitical crises and challenges remain current headwinds; yes, few feel overly confident about the tenuous state of the global economy; and yes, the recent market sell-off has only fueled legitimate concerns about the future direction of interest rates and equities.

If that were not all, the recent convening of the United Nations in New York at the end of September coincided with renewed urgency about climate change and the inability of the global community to take concerted, coordinated action only added more concern to an already anxious stew.

However, while governments have been largely inert in the face of climate change, many of the largest companies have been rapidly and radically doing what they can to reduce their environmental footprint while they, and thousands of other companies around the world, continue to grow and innovate.

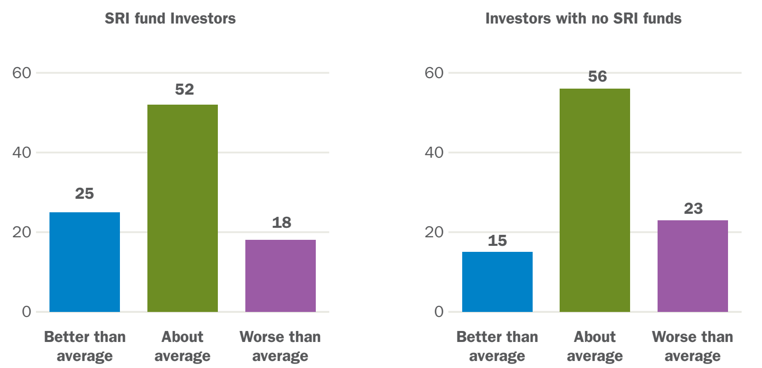
The degree to which operating businesses have embraced sustainability is not often appreciated by either the general public or by investors. But increasingly there is little daylight between companies embracing sustainable business practices and those generating substantial profits and returns for shareholders. And there are signs that investors, slowly and haltingly, have begun to recognize that.

The case for impact investing

One of the traditional obstacles to "impact" investing has been skepticism that analyzing companies through that lens has any impact (pun intended) on how they perform financially or on how their stock performs in the market.

Admittedly, "impact" is a broad term that can apply not just to sustainability and environmental/social/governance impact, but also to screening companies for moral criteria such as involvement in gambling or risqué advertising. Human rights issues also enter into this fray for impact

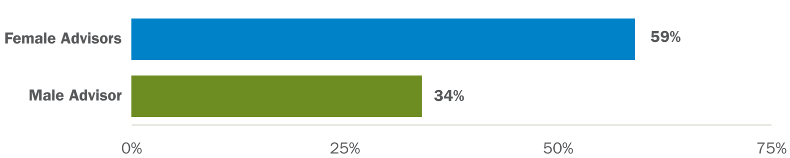
Figure 1:
Investors believe a "double bottom line" is achievable*



* In a 2014 survey of TIAA-CREF retirement plan participants, 1,000 were asked, "How would you rate the financial performance of social responsible investments compared to investments that do not take environmental and social criterial into account?"

Source: "Socially responsible investing: Strong interest, low awareness of investment options", TIAA-CREF Asset Management, January 2014. Click here for PDF

Figure 2:
Interest in recommending investments that seek to provide financial returns and environmental and social benefits



Source: "Industry Survey of Financial Advisors on Sustainable and Impact Investing", Gateways to Impact, June 2012. Click here for PDF

investors. Some investors have always wanted—and will continue to seek—portfolios that simply exclude certain companies from the investment universe based on objections to the way they operate or the industries they operate in.

But in terms of environmental impact alone, there is now a long enough horizon to assess whether there is any relationship between companies that screen well on environmental impact and companies whose stocks outperform. The lack of track records was a significant hurdle that is now being overcome, because for years, as much as some advocated more sustainability-focused investing, there just wasn't enough evidence in its support.

Much impact investing used to consist of negative screens: "I don't want this in my portfolio, I don't want that". In the past few years, there has been a shift to more dynamic, research intensive approaches that assess companies on a wide range of criteria including traditional fundamental and valuation analysis.

There is still considerable skepticism, of course. Many question whether a "double bottom line" of companies doing well in the marketplace and doing good in the world is achievable (see Figure 1). Yet there is also a marked distinction between older and younger investors, as well as between men and women. By large margins, Millennials—and younger financial advisors—express a desire to see their investments channeled towards impact investing. Women—and female financial advisors—are also significantly more likely to be actively interested in impact investing (see Figure 2).

Clearly, then, we are faced with a generational and demographic transition. We know that the future of investing lies with, well, those who constitute the future, namely the emerging generation of those under the age of 40. We know as well that more women are now earning as much as or more than men, and that women will form an ever larger percentage of investors in the coming years. Given the strong interest in impact investing that both women and younger people aver, we are almost certain to see more money flowing toward impact strategies.

And indeed, the United States lags in this respect. The Global Sustainable Investment Review found that of the $13.6 trillion of impact assets globally, Europe accounted for $8.8 trillion or 65%. In contrast, the United States, the world's biggest regional market by assets under management, contributed $3.7 trillion, or 27%[1]. Also in the United States, pension plans and endowments have taken the lead over financial advisors. The reason? Many advisors remain highly skeptical that impact investing does not lead to worse performance. They believe that if you invest according to values, you give up returns (Figure 3). And that is simply not true.

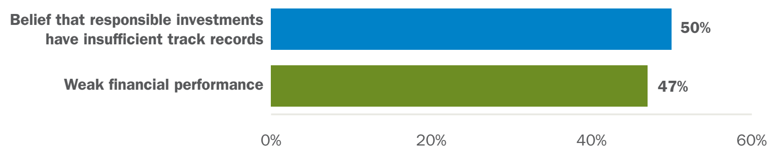
Impact returns

To begin with, no investing strategy can be said to guarantee any future performance. To demand that impact strategies must prove that they will perform well is a stretch for any fluid strategy.

The "show me" attitude towards impact investing reflects a limited understanding of what impact investing is. Yes, many funds and strategies in the late 1990s and 2000s that were presented as "environmental" or "sustainable" showed real underperformance. Often that was because the screens were binary—no oil and gas companies, no heavy industry. Sometimes it was because these funds were heavily weighted in new technologies and clean tech, all of which were (and remain) high-beta and very sensitive to economic ebbs and flows and to the price of oil and traditional energy sources.

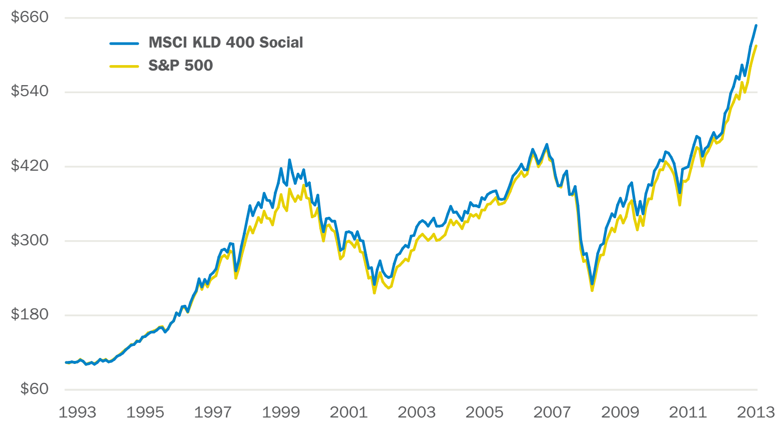
However, in the past few years, many impact strategies have been as assiduously researched and intensively vetted as any other strategy. Envestnet's quantitative research team recently released an extensive white paper assessing the multi-year performance of impact funds[2]. The result of such fundamentally based, quantitatively tested, and dynamically screened investments is that at the very least, impact portfolios perform much in line with the overall investing universe. At the very best, they generate outperformance in difficult and down markets and the best of them generate outperformance in good markets as well (Figures 4 and 5).

Figure 3:
Advisor barriers to recommending responsible investments



Source: "Industry Survey of Financial Advisors on Sustainable and Impact Investing", Gateways to Impact, June 2012. Click here for PDF

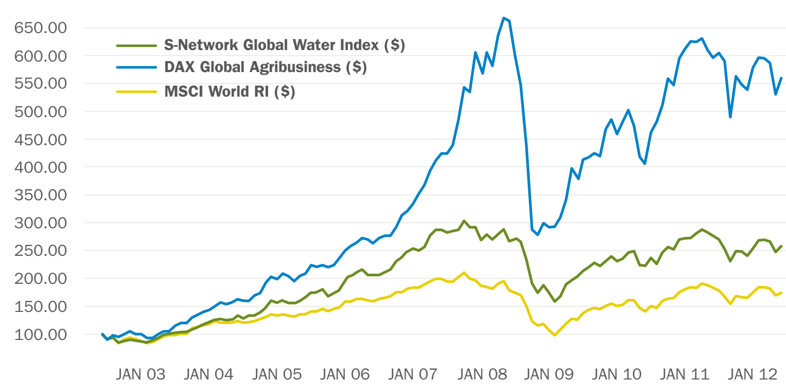
Figure 4:
Growth of $100 investment in social index (MSCI KLD 400) vs. S&P 500**



** MSCI KLD 400 is the first domestic equity index to integrate environmental, social and governance criteria

Source: Morningstar Direct, MSCI, and Standard and Poor's. Data from 8/1993 to 8/2014.

Figure 5:
Cumulative returns: water and agricultural solution providers* vs. MSCI World Index**



*** Water is represented by the S Network Water Index and Agribusiness, by the Dax Global Agribusiness Index.

Source: "Increasing Impact and Enhancing Returns: Integrating Publicly Traded Water and Agribusiness Equities into Impact Investor Portfolios", ImpactAssets, September 2013. Click here for PDF

[1] Source: "2012 Global Sustainable Investment Review", Global Sustainable Investment Alliance, January 2013. Click here for PDF

[2] Envestnet | PMC Quantitative Research Group. "How and Why SRI Performance Differs from Conventional Strategies", September 2014. Click here for PDF

The outperformance in down markets is intriguing. Envestnet's research demonstrates that the composition of impact portfolios and the individual selection of equities improve the performance in bear markets compared to funds that do not use impact criteria.

It may be that companies that screen well for impact—in terms of environmental footprint, corporate governance, and other factors—are simply better run, better managed, and have greater long-term planning than companies that do not screen well. That certainly is a compelling thesis. Many who have been long involved in this space see impact criteria as a proxy for good management and well-run companies.

Multinationals that are thinking about their input costs must think about issues such as energy consumption and how much stuff they use. Those variable costs can be the difference between margins and profits that shareholders will reward and losses that markets won't tolerate. That may be why companies ranging from Nike to Walmart to shipping giant Maersk (to name only a tiny few) have been at the forefront of innovation and reducing their carbon footprint—not because they are committed to a better planet per se, but because they are relentlessly committed to the bottom line and reducing their input costs in the form of energy and materials.

A decade ago, many of those advocating for more impact investing sensed a nearing inflection point. That has been long coming, and it has not taken the form of an "aha" moment. Instead, as more evidence mounts about the return profile of these investments and as trillions flow steadily rather than torrentially into funds and portfolios that are dynamically constructed with impact criteria embedded in the mix, impact is shifting from a niche interest to part of the landscape of how we invest. You can allocate to growth funds, value funds, macro, and dozens of others, and you can choose impact.

As a body of new research shows, impact can be a positive force not just for our collective future but for portfolio performance. If that seems boosterish, so be it. And, given our recent research, in periods where stocks are stuck on a downward rollercoaster, investing in companies that score high on impact criteria may provide some shelter in an otherwise stormy world. ■

Advisor Take-Away:

Recent surveys show that investors appear to be keen on impact investing. However, many advisors continue to be skeptical, despite the evidence that socially responsible investments can do well or even outperform their traditional counterparts, especially in down markets. That skepticism is in contrast to how companies are acting—many of them have already integrated environmental and corporate governance considerations into the way they operate. Factoring impact into client portfolios may actually contribute more to long-term performance than advisors think. And, given that women and millennials strongly favor impact investing, advisors looking to grow their business might do well to take that into consideration.

About Envestnet®

Envestnet, Inc. (NYSE: ENV) is a leading provider of unified wealth management technology and services to investment advisors. Our open-architecture platforms unify and fortify the wealth management process, delivering unparalleled flexibility, accuracy, performance, and value. Envestnet solutions enable the transformation of wealth management into a transparent, objective, independent, and fully-aligned standard of care, and empower advisors to deliver better results.

Envestnet's Advisor Suite® software empowers financial advisors to better manage client outcomes and strengthen their practice. Envestnet provides institutional-quality research and advanced portfolio solutions through our Portfolio Management Consultants group, Envestnet | PMC® . Envestnet | Tamarac™ provides leading rebalancing, reporting and practice management software.

For more information on Envestnet, please visit www.envestnet.com.