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Sustainable Investing in the United States

Abstract

The aim of the paper is to assess the performance of active sustainable investing in the U.S. particularly in the context of the rising anti-ESG movement. The paper presents the author's concept: The Seven Tribes of Sustainable Investing, which include: 1) negative screening, 2) positive/best in class, 3) impact, 4) thematic, 5) ESG integration, 6) shareholder engagement and 7) minimum standards, which have differing financial outcomes and impacts. The development and the roots of the anti-ESG movement are also synthesized. An analysis of the returns of 10 sustainable funds shows that none of these funds significantly underperformed their benchmarks over a 10-year period. These results provide a counter-argument to the proponents of the anti-ESG movement and, in particular, contradict the claims that sustainable investments do not fulfill their fiduciary duty. Therefore, the conclusion emphasizes the validity of promoting and pursuing the ESG concept against its opponents, in the U.S. and beyond.

Keywords: Sustainable Investing, sustainable funds, anti-ESG legislation, return on investment

JEL Codes: G10, G23, K22, O16

Zrównoważone inwestowanie w Stanach Zjednoczonych

Streszczenie

Celem opracowania jest ocena wyników aktywnego zrównoważonego inwestowania w USA w kontekście rozwoju ruchów anty-ESG. W artykule przedstawiono autorską koncepcję: "The Seven Tribes of Sustainable Investing" zawierająca siedem odrębnych i różniących się strategii inwestycyjnych: 1) negatywna selekcja, 2) pozytywna selekcja, 3) wpływ społeczny, 4) inwestowanie tematyczne, 5) integracja celów ESG, 6) zaangażowanie akcjonariuszy i 7) minimalne

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standardy, które prowadzą do różnych wyników finansowymi i wpływu na społeczeństwo i środowisko. Syntetycznie scharakteryzowano także rozwój ruchów anty-ESG i ich przyczyny. Z analizy zwrotów z 10 zrównoważonych funduszy wynika, że w ciągu dekady żaden z tych funduszy nie osiągał znacząco gorszych wyników od benchmarku. Wyniki te stanowią kontrargumenty dla zwolenników ruchu anty-ESG, a zwłaszcza przeczą tezom, że zrównoważone inwestycje nie spełniają obowiązku powierniczego. Dlatego w konkluzji podkreślono zasadność promowania i realizowania koncepcji ESG, wbrew jej przeciwnikom, i to nie tylko w USA.

Słowa kluczowe: zrównoważone inwestowanie, zrównoważone fundusze, regulacje anty-ESG, zwrot z inwestycji

Kody JEL: G10, G23, K22, O16

Interest in sustainable investing in all of its various forms has been on the rise in the United States for some time now[1]. With the growing interest in investment considering environmental, social and governance criteria (ESG investment), the interest of regulators and lawmakers and the number of regulations in this area have increased. It is expected that the value of ESG investment will increase significantly over the next few years. On a global basis, Bloomberg has forecasted US$53 Trillion of sustainable finance will be invested by 2025 accounting for more than a third of all global investment decisions (World Economic Forum 2022). Regardless of volatility in market conditions and geopolitical realities[2], sustainable investing in the US has seen long-term financial outperformance.

1. The Seven Tribes of Sustainable Investing

Sustainable Investing or Impact Investing are the two most frequently used overarching terms to describe what are actually seven very distinct and separate investment strategies which differ in specific practice and in financial performance.

[1] In 2019, for example, Morgan Stanley found that 95% of millennials had interest in sustainable investing (Morgan Stanley 2019). In 2020, three out of four sustainable funds identified by Morningstar (investment research firm that compiles and analyzes fund, stock, and general market data) financially outperformed their category (Hale 2021). In 2021, a majority of investors in ExxonMobil (U.S.-based oil and gas company) voted to change board members and elected at least two board candidates nominated by activist investors who pledged to steer the company toward cleaner energy and away from oil and gas. The key to making this happen was Blackrock joining a majority of financial institutions in the so-called Climate Action 100+ which features investors managing over US$68 Trillion to pass the related shareholder resolution (Climate Action 100+ 2021).

[2] As COVID's first major waves led many to work from home in 2020 into 2021, the price of a barrel of oil was briefly negative. In early 2021, as these trends continued, oil companies in Houston wondered what to do with their many thousands of engineers as long term investment projects no longer seemed financially viable let alone expected impacts with climate reality gave further pause to future activity and positioning, yet this all changed with the early 2022 invasion of the Ukraine by Russia, partnered with the rise of supply chain shortages leading to higher prices (especially oil and gas) and inflation.

The seven tribes include: 1) negative screening, 2) positive/best in class, 3) impact, 4) thematic, 5) ESG integration, 6) shareholder engagement and 7) minimum standards (Krosinsky 2023).

1) Negative Screening (excluding specific companies or sectors from a fund or portfolio), which very much represents the origins of the field of what used to be called Socially Responsible Investing. While some pension funds feel the need to be universal owners, or "own the market," some investors, whether individuals, or families, or in some cases large asset owners such as city or state pension funds, university endowments, or foundations choose not to invest in every single company or investment opportunity that might come their way for various reasons, hence the phrase negative screening. All city and state pension funds need to maximize financial returns within the asset allocation and annual return expectations that are set for their beneficiaries. Calls for divestment from a region or sector or single company are part of negative screening, but are not a primary strategy, and as such, divestment pushes often do not create meaningful change. One person or organization sells a stock, another buys those shares, and there has been no clear case of a company not having adequate investors interested if the price is right[3].

Negative screening started with calls for divestment from Apartheid in South Africa, which in some ways was an easier ask as South African business was a very small component of the global economy and corporate supply chains, versus say divestment from fossil fuel production which use is fully embedded in the supply chains of pretty much all large publicly traded companies. Again, the recent "anti-ESG" focus in the United States has come from a logical concern that if enough investors didn't want to own specific assets, it could increase the cost of capital or otherwise create a stigma on owning such assets, but sustainable investing is more than just divestment.

2) Positive Screening instead is in effect the polar opposite of negative screening or the first wave of socially responsible investing. Rather than investing in an index or market and subtracting out a few perceived bad actors (which tends not to perform all that well financially by the way, Norges Bank for example, one of the world's largest asset owners, lost money divesting away from tobacco and weapons they reported a few years ago (Katz 2018)), positive approaches look for specific opportunities, especially perhaps for solving climate change.

Such opportunities include companies providing solutions which can help make industries more efficient, or as became increasingly understood in recent years, healthcare has become a key focus for investors interested aiming to help solve

[3] There is therefore no tangible evidence that divestment causes any shift in the financial value of targeted companies, though the rise of interest in climate risk is likely to be behind the "anti-ESG" movement itself, as without adequate investor interest, stock prices can and do fall, as was seen when for example coal company Peabody Energy fell from roughly $70 a share some ten years ago to falling out of the S&P 500 for financial reasons. It can be said that calls to "ban ESG" are in effect just one more negative screen, and are similarly not the best way to optimize financial performance for investors as a result.

social challenges related to health. Venture Capital is also increasingly aimed at finding newer companies seeking to solve sustainability challenges, with over $100B invested in recent years and no slow down seen in climate focused fund activity (CTVC 2022).

3) Impact investing (investing with intention to improve the wellbeing of a target region and group of individuals) is again different, now having over $1 Trillion in investment, largely in solutions for those less well-off such as providing access to healthcare, financial services, housing, education and similar mostly private market investment opportunities (Hand, Ringel, Danel 2022).

4) Thematic investing (typically private equity or venture capital in nature and are often focused on areas such as *cleantech*/renewable energy or water among other related innovations and categories of sustainable finance) is again a unique category, and essential, with Bloomberg New Energy Finance among others calling for 3–5 times more trillions per year to solve climate change (BNEF 2022), much of this funding will come in the form of renewable energy project finance, including derisking strategies as has been largely deployed to date[4].

5) Integration (ESG integration attempts to position companies with perceived high material ESG ratings as investment opportunities that can increase a portfolio's return or lower portfolio risk) is where greenwashing concerns have largely come in to recent focus. Concerns about the quality of ESG Data are well documented (Berg, Kölbel, Rigobon 2022). ESG focused ETFs may in fact not qualify for the SEC's climate disclosure rule (now expected in Spring 2024) proposed categorizations of focus or impact, potentially making them less attractive over time for investors seeking positive impact and better financial returns (SEC 2022), further clarifying that there are many different strategies and outcomes from sustainable investing that makes categorizing ESG Investing as one thing inappropriate.

6) Shareholder engagement (when investors use their power to encourage the companies they invest in to pursue material ESG opportunities) is a longstanding practice which has established an essential otherwise missing check and balance on the financial system. Some pension funds invest in indexes and then engage with the companies they own to seek better outcomes. CalPERS, for example previously reported financial outperformance that was attributed to shareholder engagement efforts targeted at improving poorer performers on governance (Junkin 2015). The NY State Common Retirement Fund manages over $250 Billion for over 1 million beneficiaries, and has a very active corporate engagement team, and also invests over $20 Billion on sustainable finance directly (DiNapoli 2021), showing that leading investors can and often use multiple of these seven tribes in their work.

7) Minimum Standards (strategies which involve applying principles, rules, processes and norms as minimum standards for investment) represents one more methodology to "lift the tide of all boats." For example, if one visits a restaurant in

[4] Case studies for solving the SDGs using finance can be found in the InvestNYC white paper published by New York University, for example, back in 2021 (Krosinsky et al. 2021).

Manhattan, there is a letter in the window telling you whether the food is safe to eat, yet investment has not had this "seal of approval" in place historically. Increasingly, asset owners such as the Yale Endowment (YaleNews 2021), NYS Common (Krosinsky 2019) and Norges Bank (Norges Bank Investment Management) have been putting such minimum standards in place, which in Asia for example, could be quite useful for investors and society more generally if put in place comprehensively on issues such as the quality of food and drinking water.

The seven categories above represent different and unique approaches which, as one might suspect, have differing financial and impact outcomes. Investors can use none of these, one of these, some of these or all. Combinations of the above seven strands of activity are often deployed by investors when seeking to address specific issues (Krosinsky 2017). As a result of these disparate strategies, there can be certain common misunderstandings when it comes to ESG, which could be useful for readers to further reference and clarify unnecessary confusion (Krosinsky 2022). One of the dangers involves calling the entire field one thing, be it "ESG Investing" or otherwise, as is it gives space to those who want to ban altogether or slow as much as possible the potential effects of these practices.

2. Anti-ESG legislation

Momentum behind sustainable finance in the US has indeed been slowed by the rise of an "anti-ESG" movement, especially from the middle of 2022 up through the end of 2023. Some states are using their legislative power to limit ESG investing, citing concerns that ESG investing is putting policy and social objectives ahead of financial objectives, or even concerns relating to the impact that ESG investing could have on their local economies[5]. Several states have proposed or adopted new legislation that would prohibit or significantly limit their state governments from investing in ESG strategies or from doing business with financial institutions that adopt specific ESG policies (Anti-ESG Bills) (Dial, Goldberg, Mann 2022). States such as Oklahoma (Carter 2023) recently joined others such as Florida[6] and Texas (Hagan, Querolo 2023) in passing or seeking to pass legislation attempting to prevent their state pension systems from considering environmental, social, and corporate governance (ESG) issues[7].

[5] These Anti-ESG Bills vary considerably from state to state. Almost all the state Anti-ESG Bills require state entities to take certain anti-ESG actions, be it divesting from companies that engage in ESG investing or refusing to contract with companies that engage in ESG discrimination (the definition of which varies somewhat state-to-state).

[6] In 2023 Florida's Governor signed into law a bill designed to block the consideration of ESG factors in investment decisions. The law requires that investment decisions (and proxy voting decisions) for state pension assets be made on the basis of "pecuniary factors" only.

[7] The source of this "anti-ESG" movement is known and well documented, coming from funders such as Barre Seid via more visible advocates such as Leonard Leo and the Heritage Foundation (Peters 2022). Potential future Presidential candidate Ron DeSantis is among politicians which have been somewhat vocal on the "anti-ESG/anti-woke" front, arguably seeking such funding. Roughly half of US states are considered Republican, and election cycles tend to sway from left to right in the US,

A lack of uniformity among state laws in this area means businesses operating in more than one state may have to make difficult choices. The broader economic consequences of anti-ESG laws are still undetermined, but compliance with these new laws presents immediate challenges (Donefer 2023).

This sort of dilemma caused Blackrock (the world's largest asset management company, with $9.42 trillion AuM as of June 30, 2023) to not support environmental resolutions filed against companies. In 2023, the firm voted against such proposals 91% of the time (Ligon 2023), and so tangible effects of the "anti-ESG" movement are being experienced. More recent trends include antitrust legislation (Latham & Watkins 2023), and depending on election cycles, the US government may swing from allocating billions to trillions towards climate progress through the Bipartisan Infrastructure Law and Inflation Reduction Act, to implementing anti-ESG legislation at the federal and state level, making elections and the opinions of the American people most relevant as to whether progress on climate in the US will stall or proceed and at what pace.

Meanwhile, regardless of this "anti-ESG" legislation movement, active sustainable investors have been financially outperforming over the long term, earning higher returns while managing tens of billions more dollars on the back of achieving such financial success for their clients (Krosinsky, Mulji 2023).

3. Financial performance of sustainability-focused funds

Given the recent rise of "anti-ESG" legislation in some US states, the Sustainable Finance Institute (SFI) (Krosinsky, Collins Ocumarez 2023) recently endeavored to look at how sustainability-focused funds have actually been performing financially on behalf of their clients. This SFI study focused on active sustainable investors in public equity, who specifically intend and aim for maximized financial returns for their clients while prioritizing sustainability considerations at the same time. The analysis considered active fund managers with over $10 billion in assets under management, who were in operation for more than 10 years, and had accessibility to US investors where this "anti-ESG" movement has been concentrating. As below, 10 such funds were analyzed for their returns against their chosen benchmarks up through Dec 31st, 2022 (Table 1).

while socially and environmentally concerned millennials will inherit many trillions of dollars over the years to come, putting US financial institutions in a bit of a bind, trying to make everyone happy at the same time.

Table 1. The 3-, 5- and 10-year performance of active sustainable investing in the US (%)

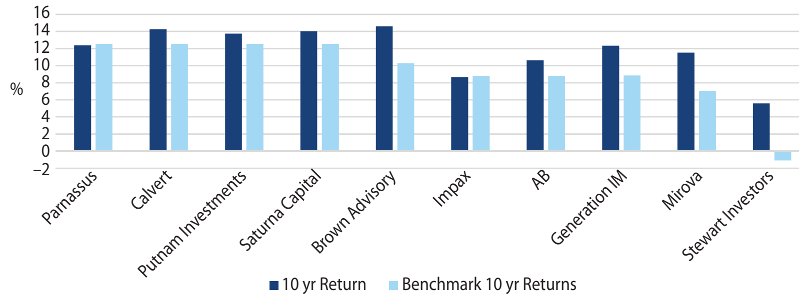
Selected Funds		Annualized Returns		
Fund Manager	**Fund Name**	**3 yr Return**	**5 yr Return**	**10 yr Return**
Generation Investment Management	Generation Core Equity	2.48	6.91	12.38
Parnassus	Parnassus Core Equity Fund	7.95	10.41	12.39
Calvert Research and Management	Calvert Equity Fund I	9.99	13.92	14.26
Putnam Investments	Putnam Sustainable Leaders Fund	7.31	10.87	13.75
Saturna Capital	Amana Growth Fund	12.09	13.92	14.02
Brown Advisory	Brown Advisory Large-Cap Sustainable Growth	7.92	12.28	14.61
Mirova	Mirova Global Sustainable Equity Fund	7.34	11.89	11.53*
Impax	Impax Global Environmental Markets Fund	5.85	5.35	8.67
Stewart Investors	Global Emerging Markets Sustainability Fund	2.12	3.19	5.57
AB	AB Sustainable Global Thematic	7.74	7.97	10.64

* Mirova Global Sustainable Equity Fund has been operating for 9.5 years. 10-year returns therefore show annualized returns since inception

Source: Sustainable Finance Institute.

Looking at 10-year annualized returns, eight of the ten funds outperformed their benchmark by a margin of 100 BPS or more (Figure 1). Four of the eight funds, the largest sustainable funds managed by Generation Investment Management, Stewart Investors, Brown Advisory, and Mirova, beat their benchmark by more than 3 p.p. On average, such sustainability-focused funds earned 2.48 p.p. more than then their benchmark. Only two funds barely underperformed, yielding returns within 30 BPS of the benchmark. Over 10 years, none of the funds significantly underperformed demonstrating some of the benefits and resilience of ESG-focused investing when placing a dual emphasis on both sustainability and financial criteria and considerations.

Figure 1. The 10-year returns of active sustainable funds in the US vs. benchmark

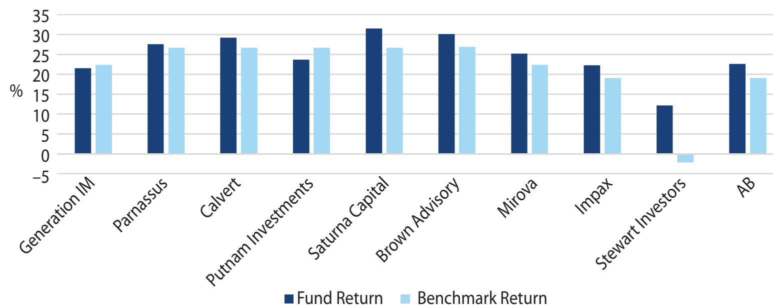


Source: Sustainable Finance Institute.

Following the worst of the COVID pandemic and related supply chain constraints, and amid heightened geopolitical tensions, 2022 was a year of turmoil for most investors, whether focused on sustainability or not. The S&P 500 fell 18% making it the worst year for markets since 2008. This shock hit fund managers across global markets including sustainability-focused investors. 8 out of the 10 funds studied underperformed relative to their benchmark during this period.

While 2022 may have been a bad year, in both 2020 and 2021 however, the investors in the study consistently beat benchmarks. For example, eight of these ten funds in 2021 beat their benchmarks with an average of 3.17 p.p. higher return across all funds analyzed (Figure 2).

Figure 2. 2021 Returns of the analyzed funds vs. benchmark



Source: Sustainable Finance Institute.

Looking at fund performance through different time periods helps frame how such funds can benefit pension fund beneficiaries and other long term focused investors.

Active sustainable investors seek to protect their clients from risks incurred by badly run companies (e.g.; recent governance scandals tend to wipe out 50 percent of shareholder value) while seizing the many opportunities emerging from ongoing innovation as well as potential shifts in consumer preference as well as across the global economy. It has also been seen that such funds often financially outperform their benchmark after fees over the longer term as well.

Outperformance for active sustainable investing has a long, positive history. In 2008, an analysis on all of the 850 funds then publicly available globally and which use sustainability as a primary consideration, found outperformance over 1-, 3- and 5-years for funds taking a positive approach (Sustainable Investing 2008).

In late 2013, exactly ten years ago, the Value Driver Model[8] study for the Global Compact and PRI (UN Global Compact) found significant outperformance for the previous 3 years for companies transforming towards sustainability in terms of increased market share from their evolving towards offering more sustainable products and services, accomplishing better risk management and achieving increased productivity from energy efficiency savings and human capital optimization strategies.

In 2018, a Brown University study found comprehensive outperformance for active sustainable investing in the US as opposed to passive approaches which did not outperform. The studies have thereby demonstrated over 3-, 5-, 10- and 20-years that active sustainable investing outperforms financially more often than not, at a time when most active managers underperform their benchmarks after fees.

This fully then refutes arguments that "ESG" necessarily leads to lower financial returns, and makes active sustainable investing the strategy of choice for investors, making this a key opportunity for all fund managers to consider to drive maximized financial performance while helping achieve societal improvement.

Concluding remarks

Considering the results of the above studies, there is little evidence to suggest that any use of ESG considerations whatsoever in a fund's primary, active investment strategy is a breach of fiduciary duty, and laws being passed to prevent such strategies from being invested in not only potentially harm financial outcomes for beneficiaries, but these "anti-ESG" laws themselves should be seen as a breach of the key fiduciary duty pillar of prudence.

Opponents of these practices argue that including ESG factors in investment decision making is a violation of fiduciary duty, arguing that investment decisions should be made solely on a company's potential returns rather than including

[8] The Value Driver Model utilizes key business metrics to determine and illustrate how corporate sustainability activities contribute to overall performance.

extraneous factors. This argument hangs on the fact that considering ESG factors will result in lower returns. In reality, ESG considerations can lead to improved financial performance as can be seen from the evidence above.

Other evidence of improved financial outcomes can be seen from the work of NYU Stern's Center for Sustainable Business (CSB) which hosts a freely accessible body of academic case studies (CSB Research) of corporate strategies which specifically lead to better financial returns while also improving environmental and social impacts.

Related to all the evidence above, let's consider the Brown Advisory Sustainable Growth Fund, which aims to invest in a concentrated portfolio of companies with internal sustainability strategies that generate tangible business benefits, such as revenue growth, cost improvement, or enhanced franchise value. This fund looks for companies whose products have a competitive advantage due to sustainability drivers, such as resource-efficient design or manufacturing, and that offer solutions to long-term sustainability challenges (Brown Advisory). Over the last ten years, the Brown Advisory Large Cap Sustainable Growth Strategy has generated an average annual return of 15%. At the same time, they seek to generate positive outcomes ranging from emission reductions to improved health outcomes.

Further, fund managers who perform shareholder engagement with public companies, such Norfolk Southern, are looking to help avoid the sort of disasters that affected so many lives in small towns such as East Palestine, Ohio in recent times.[9] Such examples of shareholder engagement are an important check and balance on the financial system which ensures corporations hear from leading investors to ensure their practices meet a minimum acceptable standard of safety for communities and employees alike, especially when governments at times remove safety protocols which can lead to less safe conditions for workers and families.

This ties to how companies are specifically governed, which when left on their own volition, can result in situations seen recently at companies such as Boeing or Southwest Airlines, who saw dramatic share price declines due to safety concerns or a lack of minimum operational competence, while trying to be too efficient on behalf of maximizing returns for shareholders. Investors focused on governance can help establish minimum standards as to how companies perform, which preserves shareholder value for investors as NY State Comptroller Thomas DiNapoli, the sole trustee of the $250 Billion NY State Common Retirement Fund recently pointed out at a Bloomberg event (Bloomberg 2023).

Governance is also essential for US investors when considering non-US investment. Asia is already half of the global economy by many measures. Without consideration of corporate governance, such investments in developing economy public companies based pretty much anywhere in Asia would be a clear breach of fiduciary duty.

[9] Norfolk Southern is rail public company operate one of the most expansive rail networks in the country. In February 2023, a Norfolk Southern train derailed in the small town of East Palestine, Ohio, marking one of the U.S.'s biggest environmental disasters in recent memory. In the following days, huge fires sent a dark cloud of chemicals and smoke into the air and over nearby towns.

Fiduciary duty would seem to require consideration of global market opportunities and whether you can trust that your money is being invested in well run companies or not, making it hard to understand how "anti-ESG" legislation can be allowed to stand up under any reasonable scrutiny.

However, there are legitimate concerns that need to be addressed when it comes to greenwashing, as well as the true impact of sustainable investing, which some find useful in so far as "field building," and which we agree on its import accordingly (Marti et al. 2023), especially when it comes to what should be the overarching goals of sustainable finance. One overarching goal realistically needs to see established that a majority of investors come to fully consider sustainability issues across all asset classes, so that these considerations become embedded into primary financial decision making. Progress has been made in this regard, but more is necessary, and the "anti-ESG" movement is just one more obstacle now to overcome.

The outperformance of active sustainable investing is an encouraging sign that "anti-ESG" efforts will not succeed for fiduciary duty reasons alone. Investors can use a dual filter of both sustainability and financial considerations going forward, as long as they employ such ESG considerations with expertise in search of better financial returns. If a majority of investors used such approaches, across all asset class, the success of these investors, as well the success of the regions and companies they invest in can be measured, arguably giving the best chance of maximizing both financial and societal outcomes going forward.

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