MERRILL
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CHIEF INVESTMENT OFFICE

Educational Series

Sustainable & Impact Investing: Back to Basics

June 2023

The sustainable and impact investing space has seen tremendous growth, both in terms of available strategies and assets under management in recent years.[1] Similarly, investor interest has continued to grow—a trend expected to continue—and we believe that investors who embrace sustainable investing practices may be better able to position their portfolios for potential long-term success. Yet, confusion abounds in the industry alongside misconceptions about what sustainable investing is and is not.

Let's clear things up

It is the Chief Investment Office's (CIO) opinion that with significant structural changes in global demographics, technology and innovation, as well as better access to data and analytical tools, sustainable investing could offer clients a powerful way to evaluate risks and uncover opportunities in the market.

Yet, the industry terminology isn't consistent, and while many once thought of sustainable investing as simply applying exclusionary screens, there's so much more to it now. There is a broad suite of solutions within sustainable and impact investing from which investors can choose.

Investment strategies tend to take one of the following approaches:

Exclusionary Screens: Seeks to exclude investments based on personal values or certain environmental, social and/or governance practices. There are typically two different approaches when applying exclusionary screens—the approach that seeks to exclude solely for risk mitigation and the approach that seeks to exclude to align with an investor's personal values. For example:

- Avoid companies with revenues from tobacco or alcohol
- Avoid companies with high risk of regulatory action due to poor labor practices
- Avoid companies associated with global sanctions violations

Removing many securities via negative screening can result in a portfolio that may have a harder time keeping up with different market environments or may even amplify risk by eroding diversification. The CIO has observed that strategies that follow inclusionary approaches may exhibit more consistent risk-adjusted returns compared to strategies applying only screens.

AUTHORED BY:

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Data as of June 1, 2023

The CIO believes three key drivers have accelerated—and will continue to accelerate growth.

- **The world is transforming** faster than ever before, spurred by technological innovation.
- **A new generation of investors has emerged** and is growing, with a desire to understand more about how their consumption and investment capital affect the world around them.
- **Enhanced data and analytical capabilities** are creating the potential for both better investment solutions and greater impact.

[1] EPFR Informa Financial Intelligence, BofA Global Research. Data as of December 31, 2022. Assets under management for seven-year period: January 31, 2015 to December 31, 2022.

ESG Strategies: While exclusions are looking to avoid risk or align portfolios with clients' values by tilting away from certain investment areas, ESG strategies seek to favor investments that incorporate positive environmental, social and/or governance practices. These companies and strategies may be competitive because they're managed with ESG issues in mind and enhance potential for long-term competitive financial returns. For example:

- Include companies that use sustainability to create a competitive advantage, for example, are more energy efficient relative to peers
- Invest in companies that lead their industry peers on metrics such as equal compensation and hiring standards, women in workforce, comprehensive family benefits
- Invest in companies that demonstrate leading environmental practices as part of a diversified approach

Impact Solutions: Investments that seek to advance positive social or environmental outcomes. This approach is about investing in companies with defined environmental or social outcomes or those that create measurable positive impact. This could include targeting opportunities where impact is intrinsic to financial performance. For example:

- Invest in healthcare companies that focus on lowering the total cost of care, improving patient outcomes, and expanding access to care
- Look for firms that are innovating to address climate, energy, water and waste issues with new products or services
- Thematic strategy with focus on Sustainable Development Goals (SDG)[2] alignment where every holding has a positive contribution

Impact Solutions can serve as a vehicle for investors who are looking to align their investments to what matters most to them and create a positive impact—the CIO Sustainable & Impact Investing Pillar Framework can help you identify those solutions.

INTRODUCING THE CIO PILLAR FRAMEWORK

If you have a cause you're passionate about or a strong desire to create potential impact in key areas, you can do so by choosing sustainable strategies aligned to your preferences. In the CIO, our strategies are aligned to three key areas: **People, Planet and Principles of Governance**, which is about how companies govern and behave. Diversified sustainable strategies may have exposures to multiple pillars, while thematic strategies may focus on just one.

People: The heart and soul of companies and communities. People are the heart of every company—from the employees to the consumers. The global economic crisis and social movements amplify the importance of our most valuable resource—human capital. When people flourish, businesses can succeed. Engaged, skilled, healthy workforces can increase a company's productivity, resilience and innovation. Thriving communities provide ecosystems for growth — and opportunities for investors. Whether you want to promote health and wellness or support companies with diverse leadership, you can make a difference with your investment choices.

Planet: Using your portfolio to invest in the future of our planet. The planet is made of interdependent ecosystems, providing natural resources that we rely on to fuel the modern world. If not managed properly, those resources can be jeopardized. The way companies manage their use of those finite resources not only has an impact on the planet but can create risks and opportunities for investors. Whether you are passionate about climate change or want to address possible climate-related risks to your investments, sustainable and impact investing can help you navigate the realities of an evolving world.

CIO Sustainable & Impact Investing Pillars

People
Commitment to engaged and healthy workers and sustainable communities

Planet
Contributions to climate and environmental sustainability

[2] United Nations Sustainable Development Goals are a collection of seventeen interlinked objectives designed to serve as a "shared blueprint for peace and prosperity for people and the planet, now and into the future". as of May 2023.

Principles of Governance: Using your portfolio to support progress toward stakeholder capitalism. Our idea of a company's purpose is changing. Investors used to expect companies to solely focus on generating profits. Now, they're expected to integrate societal impact as part of their business model. To achieve this dual purpose, companies must set up governance principles that align corporate goals and behaviors that account for the needs of all stakeholders while balancing their impact on the planet and society. Sustainable investments related to principles of governance combine two goals—to seek competitive returns and to drive responsible corporate governance and corporate behavior.

Principles of Governance
Commitment to corporate ethics and societal benefit

HOW TO GET STARTED?

There are now investment solutions available across asset classes – Equities, Fixed Income and Alternative Investments for qualified investors—and can be implemented via a suite of investment vehicles, including active[3] and passive[4] funds and separately managed accounts in public markets, as well as through the likes of Hedge Funds and Private Equity in private markets.

[3] Active management seeks to outperform benchmarks through active investment decisions such as asset allocation and investment selection.

[4] Passive management is an investing strategy that tracks a market-weighted index or portfolio.

Important Disclosures

Investing involves risk, including the possible loss of principal. Past performance is no guarantee of future results.

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All recommendations must be considered in the context of an individual investor's goals, time horizon, liquidity needs and risk tolerance. Not all recommendations will be in the best interest of all investors.

Asset allocation and diversification do not ensure a profit or protect against loss in declining markets.

Sustainable and Impact Investing and/or Environmental, Social and Governance (ESG) managers may take into consideration factors beyond traditional financial information to select securities, which could result in relative investment performance deviating from other strategies or broad market benchmarks, depending on whether such sectors or investments are in or out of favor in the market. Further, ESG strategies may rely on certain values based criteria to eliminate exposures found in similar strategies or broad market benchmarks, which could also result in relative investment performance deviating.

Investments have varying degrees of risk. Some of the risks involved with equity securities include the possibility that the value of the stocks may fluctuate in response to events specific to the companies or markets, as well as economic, political or social events in the U.S. or abroad. Investing in fixed-income securities may involve certain risks, including the credit quality of individual issuers, possible prepayments, market or economic developments and yields and share price fluctuations due to changes in interest rates. When interest rates go up, bond prices typically drop, and vice-versa.

Alternative investments are speculative and involve a high degree of risk. Alternative investments are intended for qualified investors only.

Alternative Investments such as derivatives, hedge funds, private equity funds, and funds of funds can result in higher return potential but also higher loss potential. Changes in economic conditions or other circumstances may adversely affect your investments. Before you invest in alternative investments, you should consider your overall financial situation, how much money you have to invest, your need for liquidity, and your tolerance for risk.

Private investments involve significant risks, including those associated with companies with a limited operating history, securities that do not have a liquid market, and investments that are difficult to value. They are only appropriate for investors with substantial knowledge and prior experience in making private investments, who are capable of independently evaluating the merits and risks of such investments, and who have the wherewithal to bear investment losses.

Mutual funds are subject to investment risks, including possible loss of the principal amount invested. Investment return and principal value will fluctuate so that an investor's shares, when redeemed, may be worth more or less than their original cost.