# Reviewing Our Environmental, Social and Governance Multi-Asset Class Investment Capabilities

Q&A | October 2020

pfm asset management

In an effort to provide greater insight into PFM Asset Management's (PFMAM) environmental, social and governance (ESG) multi-asset class investment capabilities and to answer some frequently asked questions regarding this increasingly important topic, we conducted the following Q&A session with Floyd Simpson and Bikram Chadha, members of PFMAM's outsourced CIO team. Floyd works with clients across the country to develop and implement multi-asset class strategies for their portfolios. Bikram is responsible for managing client relationships and supporting business development efforts for PFMAM across the Northeast region.

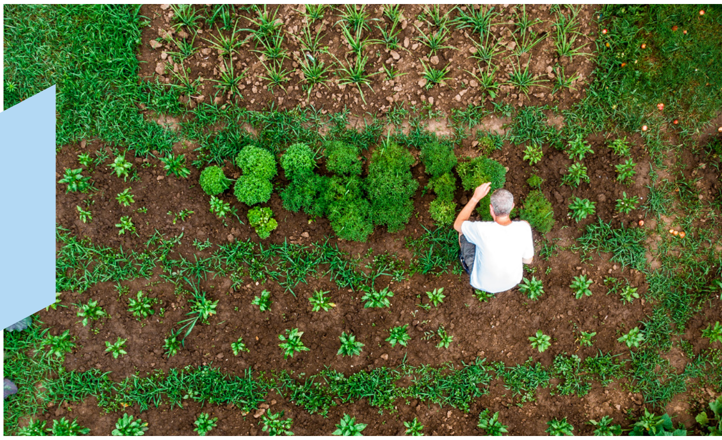
## What is ESG investing, how has it evolved in recent years and what is driving increased interest in the subject?

**Simpson:** To be clear, there is no widely accepted fixed or formal definition when it comes to ESG investing. However, in simple terms, the premise is that investors can invest in companies that uphold certain environmental, social and governance standards and seek to do so in a profitable way.

The focal points of ESG investing, if you will, most often center on the conservation of the natural world, consideration of people and relationships, and standards for running and managing a company. Again, while the definition for ESG is fairly broad and can mean slightly different things to different investors, the United Nations (U.N.) has worked to create the Principles of Responsible Investing (PRI)[1] and Sustainable Development Goals (SDG)[2], which serve as a framework for investors. ESG has been popular in Europe for quite some time, and it has been gaining significant traction in the United States over the last several years. While there are perhaps many potential drivers of this increased popularity, I suspect that the availability of alternative data on public companies has stimulated interest. Specifically, the fact that many investors are looking for ways to measure a company's ability to operate on a more sustainable basis is likely to be a driver as well.

**Chadha:** Clients have expressed interest in this topic for many years. However, the questions that investors have about the subject have clearly evolved. In other words, one might argue that the current focus is less on basic ESG education and understanding why an organization should care about the subject. More focus is on putting acquired knowledge into practice, along with a better understanding of how the investor or organization might incorporate ESG into its investment policy statement (IPS). Organizations/investors are also spending more time analyzing and formally discussing what elements of ESG investing are important to them as well as how they may go about efficiently implementing a solution.

As far as what is specifically driving interest in the subject, we believe there are several factors. For starters, the acronym ESG has become more mainstream and well-recognized in recent years, and thus, the curiosity of investors has been piqued. Another significant factor driving interest is a palpable increased sense of broader responsibility among board members/trustees/fiduciaries.



1 https://www.unpri.org/.
2 https://sdgs.un.org/goals.


Source: United Nations, https://www.un.org/development/desa/dspd/2030agenda-sdgs.html.

Of course, several other factors must not be overlooked, which are also driving investor interest in ESG. In no particular order, we believe they are:

- Growing concerns over climate change realities.
- Changing demographics (meaning Millennials and Gen-X investors, who in many cases have a different mindset than their Baby Boomer counterparts and may be more inclined to seek out sustainable investments).
- The need and/or want for "G" (in ESG). In other words, the need/demand for greater corporate transparency and accountability. Note that this is perhaps even important in the wake of COVID-19.
- Regulatory tailwinds, especially from Europe. Meaning that regulations adopted in Europe are slowly influencing policy in the United States.

## What factors should investors consider prior to implementing an ESG investment approach?

**Simpson:** Thinking in terms of the big picture, the starting point should begin with thinking about the aspect(s) that matter most to your mission and/or beneficiaries. From there, taking a broad and all-encompassing look at the investment portfolio's risk from both an investing and cash flow needs perspective might be the next logical step. Incidentally, during this initial phase, your advisor should be able to provide some education and advice as far as how to seek to accomplish your goals, along with the available bespoke strategies.

In any case, we believe the primary questions that investors should ask themselves when pondering ESG and specifically considering the implementation of a viable and practical solution should revolve around:

- What elements of ESG investing (that may be missing from our policy) are critical to our mission?
- Do we believe an ESG approach will be in the best (financial) interest of our beneficiaries?
- Will an ESG approach require additional fiduciary oversight or costs, and are these justified by the expected benefits?
- How will we be able to objectively measure success?

As an aside, there is an element of regulatory risk worth noting or considering as well. Specifically, the Department of Labor (DOL) recently came out with a proposed rule revolving around the use of ESG investments in defined contribution plans.

## CUMULATIVE INDEX PERFORMANCE — GROSS RETURNS (USD) (SEP 2007 – SEP 2020)


Source: https://www.msci.com/documents/10199/db88cb95-3bf3-424c-b776-bfdcca67d460.

Essentially the proposal seeks to make certain that investments that are made are in the 'best interests' of plan participants. In short, this is seen by some as a proposal that may make it harder to include ESG investments in retirement plans.[3]

### When it comes to ESG multi-asset class investing, what are some of the biggest challenges?

**Simpson:** From my perspective, the biggest hurdles or challenges are the breadth and depth of this strategy, coupled with the various definitions that exist concerning ESG. While the number of investment strategies utilizing ESG in their fund description has dramatically increased, filtering through those can create a hurdle or headwind regarding actual implementation.

Also, research and due diligence as well as data sources and integrity can be a challenge, as can reconciling how strategies might fit within the Principles of Responsible Investing and Sustainable Development Goals. Outlining this investment philosophy and defining both quantitative and qualitative measures are important controls that should be outlined in an investment policy. Is the goal of the organization to adopt a total ESG framework on a best efforts basis? Or is there an emphasis on the "E", "S" or "G", given your mission. Lastly, do you measure success by assessing the score of your portfolio against a defined benchmark? Or by some other measure?

### The process and thinking is, one might posit, truly part art and part science.

**Chadha:** In addition to the issues that Floyd mentioned, some other significant challenges include overcoming the perception by some that ESG investing may mean sacrificing returns, along with the perception that ESG investing is reliant on growth factors. Yet another challenge worth mentioning is that obtaining Board consensus and the will to move forward with implementing a solution may be difficult at best.

### How do you work with clients to help them understand the fundamentals of ESG investing?

**Chadha:** Each client is different and has a unique mission. My first step in the process is to conduct an informational session, where I seek to thoroughly understand what the client cares about, while also providing some education about how ESG may help the organization better address stated goals. During the meeting, I also discuss each pillar of ESG so that clients understand all aspects, why each pillar is important and how everything fits together. Our consultative approach at PFMAM leads us to be more interactive, so I spend most of the session identifying what the client truly cares about. Like any good idea, I want clients to have some reflection time as well to help ensure that we capture their intentions/wants/needs as best as possible.

3 https://www.dol.gov/newsroom/releases/ebsa/ebsa20200623.

Should there be interest in ESG factors in the investment process, the next steps involve discussing what implementation could look like and how to execute on the strategy appropriately.

### What does PFMAM offer on the multi-asset class front in terms of ESG solutions?

**Chadha:** Our approach provides clients with the tools and flexibility to implement a customized ESG investment solution through multiple methods.

The methods include:

- **Portfolio Overlay:** Using ESG considerations to make investment decisions across the portfolio.
- **Dedicated Sleeve:** Carving out a sleeve of the portfolio to implement ESG considerations.
- **Theme-Specific:** Investing in a customized ESG product that addresses a particular theme relevant to the organization's goal/needs. The implementation can be achieved through institutional mutual funds, ETFs or separately managed accounts.

### How does PFMAM go about constructing ESG portfolios for multi-asset class clients?

**Simpson:** As Bikram mentioned earlier, we utilize a consultative approach. Moreover, with every portfolio we build, the process starts with our capital market assumptions (CMAs) or views on the market from a macro perspective, leading us into the asset allocation and then, of course, to manager selection.[4]

4 PFMAM's capital market assumptions are available upon request.

Depending on the goals of a particular client, we seek to have viable options. When necessary, we have completed and can complete searches to find the managers that fit a client's specific investment policy requirements. It is important to note that the portfolios are still aligned with our overarching philosophy of relying on asset allocation to provide a bulk of the alpha for performance in these instances. In contrast, tactical positioning and manager selection offer additional avenues in seeking to increase potential portfolio returns.

### How can investors go about learning more about PFMAM's ESG solutions?

**Chadha:** Please feel free to reach out to either one of us, your PFMAM representative or email EFpractice@pfmam.com.

I should also mention that we have published several educational pieces in the newsroom section of our website that are worth consideration. Specifically, earlier this year, our Endowment & Foundation Practice published an "ESG Glossary," and our Fixed Income team published two relevant pieces. The first is a Q&A discussing ESG from a fixed income perspective. The second is a podcast about ESG investing.

For more information, please contact your PFMAM relationship manager or EFpractice@pfmam.com.

**To learn more or discuss in greater detail, please contact us:**

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