Sustainable Investing Makes An Impact

A look at why sustainable investments have seen better performance during the recent market volatility

THE 11-YEAR BULL market skidded to a halt in March, dropping nearly 34% in about a month. Businesses, theaters, schools, and restaurants shuttered their doors to protect patrons as we all practiced social distancing. As the COVID-19 cloud descended, it was hard to find a silver lining.

Sustainable investing may provide some seeding. In the first quarter of 2020, sustainable investments performed better than their conventional counterparts, with the added benefit of promoting positive change. The same factors that define sustainable investing may have helped to soften the COVID-19 economic blow.

What's Guiding This Performance?

Sustainable investing lets people build wealth in ways that support their environmental, social, and governance (ESG) principles. Most people key on environmental issues—wind farms, biodiversity, sustainable fishing—and including or excluding companies based on personal values. But sustainable investing also means investing in companies that support and exhibit ESG principles in their structure and how they do business. This includes policies on diversity in hiring, employee safety measures, and even financial soundness.

According to Morningstar, an investment research company, during the first quarter of 2020, sustainable investing equity funds held up better than their conventional peers. One reason for the better performance may have been that sustainable funds have less exposure to energy stocks than market indexes, and the energy sector declined about 50% in the first quarter of 2020.

Another potential factor is that sustainable investments have a higher allocation to "high-quality" companies—companies with strong financials. Sustainable investing includes looking for companies that exhibit better ESG ratings relative to their peers. These companies typically have fewer hidden risks, known as off-balance sheet liabilities, and are positioned to better withstand unexpected events—like a global pandemic.

It makes sense that sustainable funds would hold up well in a market impacted by a global pandemic because these funds—and their managers—already have taken steps to develop policies addressing ESG concerns, such as scarce resources, employee relations, and board structure. Their long-term planning, transparency, and ESG policies were designed, in part, to help them weather crises.

There are a few theories that help illuminate why sustainable funds may be performing better right now:

- **LESS EXPOSURE TO ENERGY STOCKS,** whose sector declined about 50% in the first quarter of 2020. Sustainable funds typically have less exposure to those stocks compared to market indexes.
- **ALLOCATION TO "HIGH-QUALITY" COMPANIES,** such as those with strong financials and those with better ESG ratings than their peers. These companies typically have fewer hidden risks and are better positioned to withstand unexpected events like a global pandemic.
- **POLICIES ADDRESSING ESG CONCERNS,** such as scarce resources, employee relations, and board structure, which help these companies weather crises.

Sustainable Investing in Action

Sustainable investing also incorporates corporate governance, often in the form of shareholder action. In the early stages of the COVID-19 pandemic, sustainable investors urged the business community to take specific actions. Shareholders looked to companies with sustainable practices to provide benchmarks on paid leave, the health and safety of workers, supplier and customer relationships, financial prudence, and other crisis concerns.[1]

Sustainable investing lets people build wealth in ways that support their ESG principles.

The human toll from COVID-19 has been enormous, and we're still gauging the long-term physical and emotional impact of this vicious virus. While people are fighting for their lives, they're struggling to pay rent and utilities and even put food on their tables. The impact to people and communities has been enormous, and unfortunately, the greatest impact has been on the most financially vulnerable.

This is where the community-oriented aspect of sustainable investing comes into play. Options such as government-backed securities provide a financial infusion for underserved and economically disadvantaged communities while delivering a reasonable return on investment.

As part of the 2020 stimulus packages, mortgage giants Freddie Mac and Fannie Mae have instructed lenders to be more flexible with borrowers, providing some relief to the same people the sustainable investing strategy was trying to support. At the same time, the agency backing of the underlying loans helps assure investors they will continue to receive the expected return on their investments each month.[2]

Looking Beyond COVID-19

Sustainable investments performed as well as expected in the first quarter, which was consistent with longer-term performance. The MSCI KLD 400 Social Index provides exposure to companies with strong relative ESG ratings and excludes companies whose products have negative social or environmental impacts. Since its inception in May 1990, the MSCI KLD 400 Social Index has outperformed the S&P 500 Index.

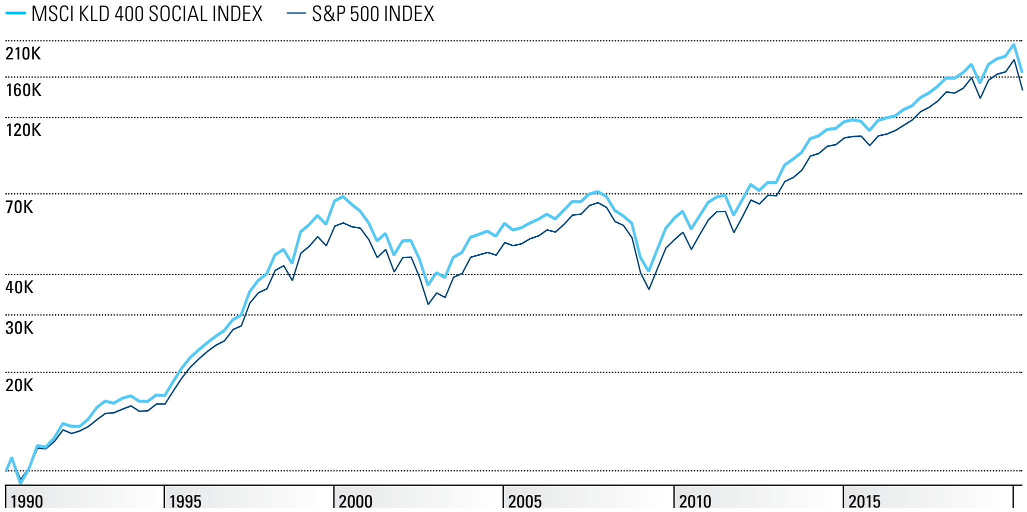
In addition, flows into sustainable investing funds during first quarter 2020 surpassed those in fourth quarter 2019, setting a new record.[3] Obviously, investors are

1: Investor Statement on Coronavirus. Domini. March 26, 2020

2: RBC Access Capital Strategy Update. RBC Global Asset Management. April 1, 2020.

3: Despite the Downturn, U.S. Sustainable Funds Notch a Record Quarter for Flows, Morningstar, April 9, 2020

MSCI KLD 400 SOCIAL INDEX VS. S&P 500 INDEX



Source: Morningstar Direct, 04/21/20

starting to see returns from putting their money where their allegiances lie.

While first quarter sustainable investment performance in 2020 was positive, the bigger impact has been to inspire leadership in the business community in response to the COVID-19 pandemic. It has also provided support for people financially impacted by the economic shutdown through community investing initiatives. This exemplifies the full performance impact of sustainable investing: corporate governance, community influence, and monetary returns.

What's Available at LPL?

LPL Financial offers access to a variety of sustainable investing choices, ranging from exchange-traded funds (ETF), mutual funds, separate account managers, and centrally managed turnkey portfolios. LPL Research provides due diligence and recommendations for third-party investment managers that are also sustainable investing leaders.