BNY MELLON INVESTMENT MANAGEMENT

Classifying Responsible Investment

February 2018

Seyi Bucknor, *Co-Head, Manager Research Group*

Elise Schroeder, *Senior Analyst, Manager Research Group*

When investors choose to invest in responsible investment (RI) strategies, we believe they are trying to accomplish one or more of the following objectives:

- Values Expression
- Influence Change
- Return Enhancement

Overview

Let's begin by looking at two numbers: $8.72 trillion and 33%. These figures represent, respectively, the total U.S.-domiciled assets invested in sustainable, responsible, and impact investing strategies and the percentage increase in such assets between the start of 2014 and the beginning of 2016.[1] With such explosive growth and seemingly rising popularity, one would assume that responsible investment (RI) was a well-defined market where client assets seeking suitable investments were easily matched, but this is not the case. RI traces its roots back over 60 years, but despite such history there is still a surprising lack of clarity about the opportunity set and value proposition. Thus, asset managers and clients alike are still unsure of the appropriate terms to use when describing the space.

What we present in this brief is a framework for classifying the responsible investment opportunity set. It attempts to clearly characterize and target investors by the motivations that attract them to the space. The resulting taxonomy is thus more intuitive and speaks directly to the value proposition of each category of strategies.

The existing RI taxonomy comprises a collection of inconsistent labels, including Negative Screened, ESG (environmental, social, and governance) Integration, Thematic, and Impact Investing strategies. Such categories are related, but not directly comparable. For example, the Thematic investment category refers to strategies which invest in specific thematic opportunity sets, such as clean energy or gender diversity. On the other hand, the ESG Integration category draws its name from a portfolio construction approach where investment teams integrate insights on environmental, social, and governance risks and opportunities with traditional fundamental research. The incongruity of using investment opportunity sets (Thematic) and portfolio construction approaches (ESG Integration) as reference points on a single continuum of investment operations is indeed comparing apples to oranges.

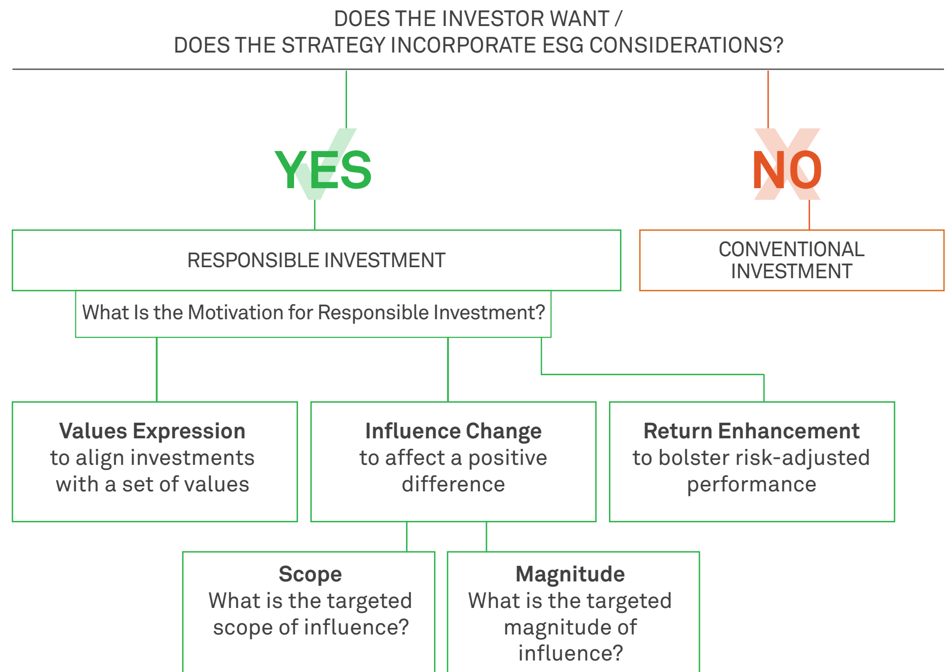
Our second observation about current naming conventions, and by extension many of the products competing in this space, is that they fail to connect with investors by conveying a clear value proposition. That is, they neither articulate an extra-financial objective (or what the product seeks to do *for* the client) nor are they clear on how those objectives are met. Value to responsible investors is delivering both financial and extra-financial objectives, and asset managers need to better understand the motivations of this client segment if they are to successfully deliver products that meet its needs and deliver its desired outcomes.

Not FDIC-Insured. Not Bank-Guaranteed. May Lose Value.

BNY MELLON

RI Classification Flow Chart

Classification of responsible investment objectives from the perspective of both an investor and an investment manager. Clarification of RI objectives may be useful in matching investor motivations with investment strategy outcomes.



What follows is a framework that will refocus the RI discussion around investment outcomes by linking the motivations and values that drive responsible investors to the attributes and objectives of RI products.

Responsible Objectives

When investors choose to invest in RI strategies, we believe they are trying to accomplish one or more of the following objectives. First, they may be seeking alignment between their invested capital and a personally held principle or ethic; we'll refer to this objective as Values Expression. Second, investors may be using their capital to affect outcomes in a broad range of interests; we'll label this objective or motivation as Influence Change. Finally, there are those investors who believe that integrating ESG information with traditional investment processes can positively impact risk-adjusted returns; we'll refer to this objective as Return Enhancement. It is important to note that these objectives are not mutually exclusive; on the contrary, RI strategies often emphasize several objectives simultaneously.

Values Expression describes the intent of investors for whom there are benefits to having their investments aligned with an extra-financial principle. When client capital is invested in a way that directly or indirectly supports practices that conflict with the client's views, there is a misalignment of interests. Strategies in the Values Expression category give clients an opportunity to align their investments with personal extra-financial principles; common criteria center on mission, faith, and human rights principles. In practice, Values Expression portfolios are often constructed by using front-end exclusionary screens; it is from this type of exclusionary strategy that socially responsible investment (SRI) has its roots.

While the benefits of a Values Expression mandate accrue mostly to the investor, the motivation for clients in the **Influence Change** segment reaches beyond individual interests as invested capital now becomes a means to drive organizations to pursue sustainable business practices that affect multiple constituencies. These sustainable business practices introduce the concept of shared value, where a company's business operating policies and procedures look to enhance the economic and social conditions of *all stakeholders*, e.g., employees, customers, and the communities in which the

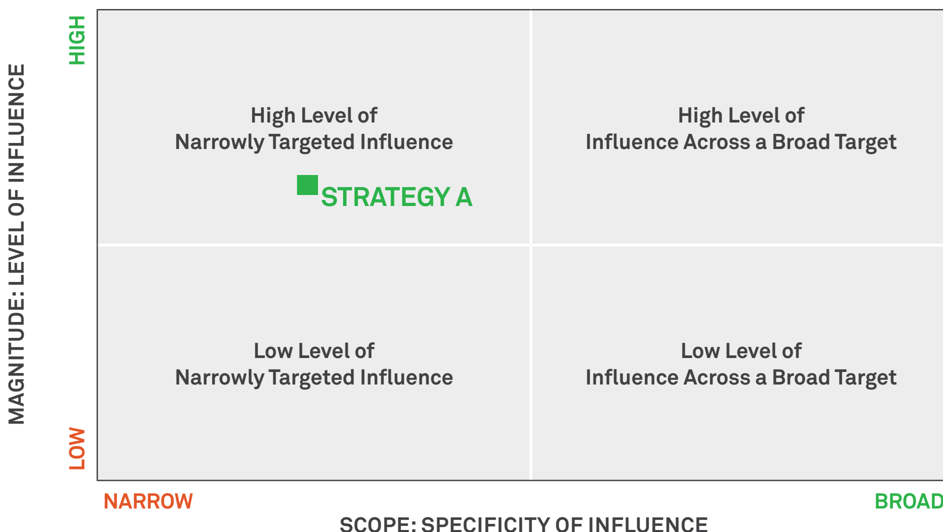
business operates. This triple-bottom-line framework for allocating capital evaluates prospective investments by their social, environmental, *and* financial performance. Strategies in the Influence Change category can produce two types of outcomes. These strategies can either seek a positive impact on the ESG practices of businesses (i.e., driving change within an organization) or attempt to advance the objectives of organizations with impactful business models that address environmental and social challenges (e.g., startups building innovative education tools or sustainable energy technology). Investment strategies in the Influence Change category can be characterized further by the **Scope and Magnitude** of their impact. Here we use scope as a reference to the breadth of a strategy's influence and magnitude as a subjective measure of the depth of influence a strategy may achieve. For example, a strategy with broad scope may affect multiple stakeholder groups across a multitude of material environmental, social, and governance issues. Scope in effect answers the question: "How many people are we impacting?" Magnitude, on the other hand, speaks to the intensity of change brought about by the investment strategy; it answers the intuitive follow-up inquiry: "How deeply are target stakeholders affected?"

	STRATEGY A
Values Expression	☐
Influence Change	☑
Scope: Issue	Narrow ··X························ Broad
Scope: Stakeholders	Narrow ··X························ Broad
Magnitude	Low ·························X··· High
Return Enhancement	☑

Responsible Investment Classification

RI strategies are classified according to objective. Strategies which seek to influence change are further characterized by the magnitude of influence they may affect, and the scope of influence by targeted issue (such as the environment, affordable housing, or governance practices) and by targeted stakeholders (such as a demographic or geographic area). For illustrative purposes only.

Scope and Magnitude are functions of the change mechanisms exercised by the investment manager, and these mechanisms are largely determined by asset class and strategy type. Change mechanisms should be thought of as the means by which RI strategies influence behavior and drive sustainable development; strategies are likely to affect change by employing several mechanisms simultaneously.



RI Strategy Map: Scope and Magnitude of Influence

An RI strategy map visualizes characterization of strategies in the Influence Change category. An RI strategy is mapped according to target scope of influence (how many people are we impacting?) and potential magnitude of influence (how deeply are target stakeholders affected?). For illustrative purposes only.

Primary mechanisms, or those that can directly influence the policies and operating decisions of an organization, come through direct ownership that gives the investment manager, and by extension the client, the leverage to drive change from within an organization. An investor may exercise ownership by casting shareholder votes on ESG issues. Naturally, an investor's ability to affect change through a primary mechanism is proportional to the size of the ownership stake. Private market Impact Investments are the archetypal strategy in that not only is there direct equity ownership in an organization, but there are also clearly defined sustainable development goals that can be matched with investor objectives. Here, instead of allocating capital to bring corporate and investor goals into alignment, capital is sourced to expressly drive investor outcomes.

Secondary mechanisms for change rely primarily on signaling; here, communication and persuasion are the tools of engagement. Investment managers employ secondary mechanisms by elevating public and company awareness of various ESG issues; by informing and mobilizing the former (who can be customers, employees, and investors in the latter), investment managers can pressure companies to change corporate behavior.

Investors who look to RI for **Return Enhancement** believe that environmental, social, and governance issues may affect the performance of a company and ultimately the price of its publicly traded securities; in essence, ESG risks and opportunities represent an additional data source that may enhance the investment decisions of a research analyst or portfolio manager. This position, which is held by many RI investors and is the basis of a growing body of academic research,[2] contends that ESG factors represent material risks and opportunities to a business that should be integrated with traditional fundamental research in support of portfolio risk-adjusted performance.

Conclusion

Values Expression, Influence Change, and Return Enhancement are categorizations that transcend asset classes, strategy types, and investment processes and thus provide a taxonomy that may be consistently applied across the product landscape. This classification framework focuses on the motivations that drive clients to RI and links these preferences to clear and intuitive investment strategy objectives. By understanding this link, we believe this framework enables advisors and asset managers to be better equipped to identify the outcomes sought by clients and, subsequently, to more effectively position their products.

---

[1]The Forum for Sustainable and Responsible Investment.

[2]Khan, Mozaffar and Serafeim, George and Yoon, Aaron S., Corporate Sustainability: First Evidence on Materiality (November 9, 2016). *The Accounting Review*, Vol. 91, No. 6, pp. 1697-1724.. Available at SSRN: https://ssrn.com/abstract=2575912 or http://dx.doi.org/10.2139/ssrn.2575912.

All investments involve risk, including loss of principal. Certain investments involve greater or unique risks that should be considered along with the objectives, fees, and expenses before investing. Socially responsible portfolios may forgo opportunities to invest in other securities when advantageous, or may sell securities when disadvantageous for them to do so while pursuing their socially responsible criteria.

BNY Mellon is one of the world's leading asset management organizations, encompassing BNY Mellon's affiliated investment management firms, wealth management services and global distribution companies. BNY Mellon is the corporate brand for The Bank of New York Mellon Corporation.

Views expressed are those of BNY Mellon Investment Management and do not reflect views of other managers or the firm overall. Views are current as of the date of this publication and subject to change. This information should not be construed as investment advice or recommendations for any particular investment. Please consult a legal, tax or investment advisor in order to determine whether an investment product or service is appropriate for a particular situation. No part of this material may be reproduced in any form, or referred to in any other publication, without express written permission. The Dreyfus Corporation and MBSC Securities Corporation are companies of BNY Mellon. ©2018 **MBSC Securities Corporation**, Distributor, 225 Liberty Street, 19th Floor, New York, NY 10281.

MARK-15114-2017-11-27
BNYM-CRIWP-0218