ESG Investing
Sustainable Strategies, Competitive Return Opportunities
The future may be now for sustainable investing based on Environmental, Social and Governance ("ESG") principles. In years past, it was commonly believed that investing responsibly meant sacrificing returns. While this perception may have been true at one time, sustainable investing has evolved in recent years, growing from a strategy that simply excluded certain industries like tobacco and firearms, to a more comprehensive strategy that has the potential to outperform traditional investing techniques. And as described later, studies indicate that this prudent, pragmatic approach has helped lower fundamental business risk for certain companies employing ESG strategies.

In this white paper, we discuss how ESG investing has grown dramatically in popularity, particularly in the U.S. In the 10-year period ended April 2017, professionally managed assets incorporating ESG criteria have increased by a 25% average annual rate to $68.4 trillion.¹ We also delve into empirical data and academic studies that show how ESG investing has historically earned higher returns with lower volatility over the long term. In addition, we show how companies that incorporate ESG principles have improved shareholder value, and highlight how the potential growth in demand from a range of investors, including Millennials, high-net-worth individuals, and institutional investors, may impact the development of this investing strategy in years to come.
The Many Forms of Sustainable Investing

Sustainable investing is an umbrella term for investment disciplines that consider Environmental, Social and Governance criteria when selecting a company stock. Sustainable strategies go by a tangle of many names that are not uniformly applied and sometimes lack distinction, including Ethical, Green, Impact, Mission, Responsible, Socially Responsible, Sustainable and Values. All of these strategies, however, regardless of the label, use ESG criteria and can be classified into three general strategies:

1. **Socially Responsible Investing (SRI).** The origin of today’s ESG-based investing is Socially Responsible Investing, which became available to the American public in the 1970s when the first SRI mutual fund was launched. SRI screens out so-called “sin” stocks that clash with an investor’s values (commonly known as “negative screening”), such as weapons, alcohol, tobacco or gambling. This investing practice shrinks the universe of opportunities creating portfolio gaps and reducing potential return. By negatively screening investments, the SRI strategy may exclude companies that are “sinful” in some areas but implemented positive, sustainable practices in others.

2. **Environmental, Social and Governance (ESG).** Over the last decade, sustainable investing evolved from SRI avoidance strategies to focus on identifying companies with positive ESG practices. ESG investing uses a holistic approach to evaluate how a company’s operational activities are impacting its employees, customers, society and the environment (See Figure 1). In contrast with Socially Responsible Investing, ESG investing evaluates a company’s impact as the sum of its individual practices rather than eliminating specific companies or industries based on a simple screening process.
As shown later in this paper, ESG factors can help mitigate investment risk by identifying companies exposed to material ESG risks including potential legal or regulatory liabilities that can damage their brand. Material ESG risks differ with each company and can range from environmental pollution for an energy company to human rights abuses for a clothing manufacturer. The following are examples of a corporation’s investment in ESG principles that could improve its “sustainability” rating:

- **Environmental**: Invest in technology to reduce emissions
- **Social**: Adopt a procurement policy that increases outsourcing costs but ensures the highest level of compliance with human rights standards
- **Governance**: Create a formal system to remedy ethical concerns reported by employees

3. **Impact.** Another form of sustainable investing that uses ESG principles is Impact investing. A more direct approach to improving global sustainability, Impact investing puts investor capital to work in companies, organizations or projects whose core mission is to generate financial return along with measurable improvement in global sustainability. Impact investing provides community products and solutions like clean water, housing, education, jobs, and business growth.
ESG Investing—Not Just a Niche Anymore

ESG investing has rapidly gained momentum, driven by a growing social consciousness movement, new ESG data and analysis, and mounting evidence that companies with strong ESG strategies have been more profitable. At the start of 2016, more than one-quarter of professionally managed assets, or $23 trillion, were invested worldwide with companies that consider sustainable investing criteria, up 25% from two years prior. The United States has been rapidly catching up. In 2016, one of every five dollars under professional management in the U.S. was invested according to ESG principles. Nearly one-third of this was in mutual funds, with the balance in non-public accounts, including pension funds and endowments.

As the numbers below suggest (Figure 2), sustainable investing has entered the mainstream. In 2011, the Sustainability Accounting Standards Board (SASB), a nonprofit organization, issued accounting standards, paving the way for investors to evaluate a company’s ESG fundamentals. These accounting standards enable multiple financial data providers to offer standardized, comparable information on hundreds of ESG metrics to make in-depth analysis easier for institutional and individual investors. In 2016, Morningstar and MSCI each launched Sustainability Ratings, providing retail investors with the tools to evaluate and compare mutual funds and other investment portfolios, based on sustainable investing principles. Morningstar calculates its Sustainability Ratings based on the underlying fund holdings and company-level ESG ratings and research from Sustainalytics.

FIGURE 2

U.S. Assets Under Management Using ESG Criteria

Source: US SIF (ussif.org/trends)
The chart above does not predict future assets under management or the performance of any specific investment.
ESG-Friendly Companies Historically Outperformed Their Traditional Counterparts

Dispelling pervasive misconceptions, a large body of empirical research conducted in the last decade shows that companies that effectively address their material ESG risks have comparable and sometimes higher profitability, lower cost of capital and more opportunities to enter new markets than those that do not employ ESG strategies. A recent Harvard Business School study concluded that companies “making major investments in material ESG issues experienced both higher growth in profit margins and higher risk-adjusted stock returns than otherwise comparable companies.” These findings—and those of many similar academic studies—refute conventional thinking that investors had to sacrifice return opportunities to invest responsibly.

Given these positive findings, many corporate managers and investors have started to embrace the potential benefits of ESG investing. The percentage of S&P 500 companies reporting ESG data surged from just 20% in 2011 to 85% in 2017. This trend may continue as more studies investigate the correlation between ESG practices and shareholder value, based on the most recent study (see Figure 3 below).

**FIGURE 3**

*Evolution of $1 Invested in the Stock Market in Equal-Weighted Portfolios of Companies Adopting/Not Adopting Certain Environmental and Social Practices*

![Graph showing the evolution of $1 invested in the stock market in equal-weighted portfolios of companies adopting/not adopting certain ESG practices.](image)


**Note:** Past performance is not a guarantee of future results.
ESG Investing Has Outperformed Over the Long Term

ESG stocks as represented by the MSCI KLD 400 index have corroborated the academic research. The MSCI KLD 400 Index—one of the first indexes designed to provide exposure to U.S. companies with positive ESG practices—has outpaced the S&P 500 Index since its inception in 1990 through March 2018 (see Figure 4). The performance illustrates that omitting stocks with poor ESG practices has historically led to positive index returns. Past performance does not guarantee future results.

Note: Past performance is not a guarantee of future results. This chart does not reflect the performance of any specific investment.

Source: MSCI, Standard & Poors.

This chart covers the period from July 1, 1990 through March 31, 2018 and assumes that any cash distributions, such as dividends, are reinvested. Returns do not take into account any taxes or fees. The MSCI KLD 400 Social Index is a capitalization weighted index of 400 US securities that provides exposure to companies with outstanding Environmental, Social and Governance ratings and excludes companies whose products have negative social or environmental impacts. The S&P 500 Index is an unmanaged, broad-based, market-cap weighted index of 500 U.S. stocks. Indexes are not managed. Individuals cannot invest directly in an index. The launch date of the MSCI KLD 400 Social Index was May 1, 1990.
Millennials Have Helped Drive Growth in ESG Investing

More than 120-million strong, the Millennial generation and their older siblings, Generation X, are a powerful force. Together they are set to inherit an estimated $41 trillion over the next 40 years from the Baby Boomers, according to the World Economic Forum (WEF), in the biggest generational wealth transfer in history. By 2020, Gen X and Millennials will control more than half of all investable assets—about $30 trillion, according to a recent survey by PwC.

These generations, especially the Millennials—those born between 1982 and 1998—have markedly different attitudes toward the role of business in society. In a 2018 study by Deloitte of 10,455 college-educated Millennials across 29 countries, three-quarters of respondents believed that multinational corporations that engage in ESG principles have the potential to solve society’s economic, environmental and social challenges. As illustrated in another study and shown in Figure 5 below, 76% of Millennials surveyed have reviewed their portfolio assets based on ESG impact, which suggests the demand for sustainable investments may continue to rise. Though less open than Millennials to ESG investing, Baby Boomers are also enthusiastic. Twenty-nine percent of those surveyed have reviewed their portfolios for societal impact, and another 10% already own impact investments. Across all age groups, the highest rate of ownership and interest in sustainable investing came from ultra-high-net-worth investors (UHNW), defined as those with at least $10 million in investable assets.

FIGURE 5

Investors Today Are More Interested in Social Impact Investments

| % of Investors Who Own or Are Interested in Social Impact Investments –2017 |
|-----------------------------|-----------------------------|
|                             | Interested but don’t own    |
|                             | Own                         |
| All                         | 90%                         |
| Millennials                 | 80%                         |
| Gen X                       | 70%                         |
| Baby Boomers                | 60%                         |
| Mature                      | 50%                         |

Source: US Trust Bank of America Private Wealth Management, Insights on Wealth and Worth Survey 2017. The survey included 684 individuals with at least $3 million in assets representing four generations: Millennials, Gen X, Baby Boomers and Mature. Men accounted for 60% of the respondents, women were 40%. In terms of net worth, survey respondents were divided into the following groups: 40% with assets between $3 million and $4.9 million; 36% with assets between $5 million and $9.9 million; and 30% with assets of $10 million or more.
How Can ESG Standards Improve Corporate Performance?

Companies—and in turn their shareholders—may benefit from investing in ESG practices and principles on multiple levels, according to a Harvard Business School report. Among the advantages, ESG strategies may:

- **Lower the cost of capital.** Adopting strong governance practices may help lessen the chance for shareholder and employee lawsuits, and government investigations. In turn, lenders may require a lower risk premium and shareholders lower valuation multiples.

- **Attract key shareholders.** Public pension funds and investment entities represent a huge and relatively stable, long-term source of capital for public companies. Until recently, the managers of those assets were confined by a narrow interpretation of fiduciary duty that focused almost exclusively on short-term financial returns. In the past few years, that fiduciary definition has expanded, removing the regulatory roadblocks to ESG investing for fiduciary-led accounts. In October 2015, the United States Department of Labor released guidelines allowing pension fiduciaries to add ESG investments to their line-up. The United Nations Principles for Responsible Investment (UNPRI) went a step further, issuing an opinion that institutional investors’ fiduciary duty requires them to incorporate ESG criteria into investment analysis and decision-making processes. While their principles for responsible investing are voluntary, the UNPRI has more than 1,900 signatories from over 50 countries, representing $82 trillion in invested assets.

- **Improve a company’s reputation.** By implementing ESG practices and promoting these practices in traditional and online media, companies can potentially build good will, improve their corporate citizenship and enhance relations with all key stakeholders—shareholders, employees, customers, suppliers and the local communities where the business operates.
Concluding Summary

Sustainable investing has come a long way since the SRI avoidance strategies of the last century. ESG strategies have become a recognized approach for merging the desire to make an impact socially with the need for a competitive return. Indeed, this market-based model of sustainability has produced synergies by enabling multiple stakeholders to benefit and contribute toward greater shared value. Looking forward, investor demand may accelerate as more companies recognize potential competitive advantages from ESG strategies, new regulations make ESG criteria more acceptable fiduciary goals, and investors eye return opportunities that provide positive social impact.

■ Encourage innovation. Many companies have integrated ESG practices to create market opportunities. Those that approach ESG integration as a source of innovation have outperformed their peers that approached it purely as a risk management tool. Here are just two examples of companies that have increased revenue while managing business risk\textsuperscript{12} and improving operational efficiency:\textsuperscript{13}

• A multinational chemical company shifted dramatically from a risk management stance to one using sustainability-driven strategic planning, spurring several innovations and a business helping customers address their own environmental challenges—a $350 billion market opportunity.

• A global industrial conglomerate launched a successful ESG initiative. The initiative’s $17 billion investment in R&D over the last decade has generated $232 billion in revenue, while materially reducing greenhouse gas emissions and its use of fresh water.

\begin{itemize}
\item \textsuperscript{1}US SIF (ussif.org).
\item \textsuperscript{2}Sustainalytics provides analysis on more than 6,500 companies across 42 sectors. Morningstar provides Sustainability Ratings for roughly 20,000 mutual and exchange traded funds, based on company-level ESG scores from Sustainalytics.
\item \textsuperscript{3}Global Sustainable Investment Alliance (GSIA).
\item \textsuperscript{4}Kotsantonis, Sakis and Pinney, Chris and Serafeim, George, ESG Integration in Investment Management: Myths and Realities (Spring 2016). Journal of Applied Corporate Finance, Vol. 28, Issue 2, pp. 11-12, 2016.
\item \textsuperscript{5}Governance & Accountability Institute, March 2018.
\item \textsuperscript{6}World Economic Forum (WEF), From Margins to the Mainstream, September 2013, page 5.
\item \textsuperscript{7}PwC, 2016 Wealth Management Trends, page 5.
\item \textsuperscript{8}Deloitte, The 2018 Deloitte Millennial Survey, page 6.
\item \textsuperscript{9}U.S. Trust Bank of America Private Wealth Management, Insights on Wealth and Worth Survey 2017.
\item \textsuperscript{10}Kotsantonis, Sakis and Pinney, Chris and Serafeim, George, ESG Integration in Investment Management: Myths and Realities (Spring 2016). Journal of Applied Corporate Finance, Vol. 28, Issue 2, pp. 10-16, 2016.
\item \textsuperscript{11}Tonello, Matteo and Singer, Thomas, The Conference Board, Corporate Investment in ESG Practices, August 2015.
\item \textsuperscript{12}Business risk is the risk inherent in the firm’s operations. Risk can come from numerous factors, including violations of regulations and laws pertaining to environmental, social and governance issues.
\end{itemize}
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Timothy Pettee is Chief Investment Officer and Chief Investment Strategist at SunAmerica Asset Management, with more than 30 years of investment experience. Prior to joining SunAmerica, Mr. Pettee was Executive Vice President and Global Director of Research for Schroder Investment Management. He was also Director of Research with U.S. Trust Company of New York and co-managed that firm’s small-cap retail funds and research core products. He previously held several positions in research and portfolio management at Alliance Capital Management.

**About the Company**

SunAmerica Asset Management, LLC, a member of American International Group, Inc. (AIG), managed, advised or administered over $89 billion in assets as of June 30, 2018 across multiple business lines, including AIG’s retail family of mutual funds.

AIG Funds provides a broad range of equity and fixed income offerings, including innovative products that feature global asset allocation and focused and alternative investment strategies. We take pride in our history of developing and introducing new ideas across investment disciplines. Our investment management combines strong in-house portfolio managers along with independent money managers. We currently have sub-advisory relationships with highly respected firms including BAMCO, Inc., BlackRock Investment Management, LLC, Cadence, Cohen & Steers, Marsico Capital Management, LLC, Newfleet Asset Management, LLC, PineBridge Investments, LLC, and Wellington Management.

For more information about this whitepaper or AIG Funds, please contact your financial advisor or visit aig.com/funds.
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 Investors should carefully consider a fund’s investment objectives, risk, charges and expenses before investing. The prospectus, containing this and other important information, can be obtained from your financial advisor, the AIG Funds Sales Desk at 800-858-8850, ext. 6003, or at aig.com/funds. Read the prospectus carefully before investing.

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