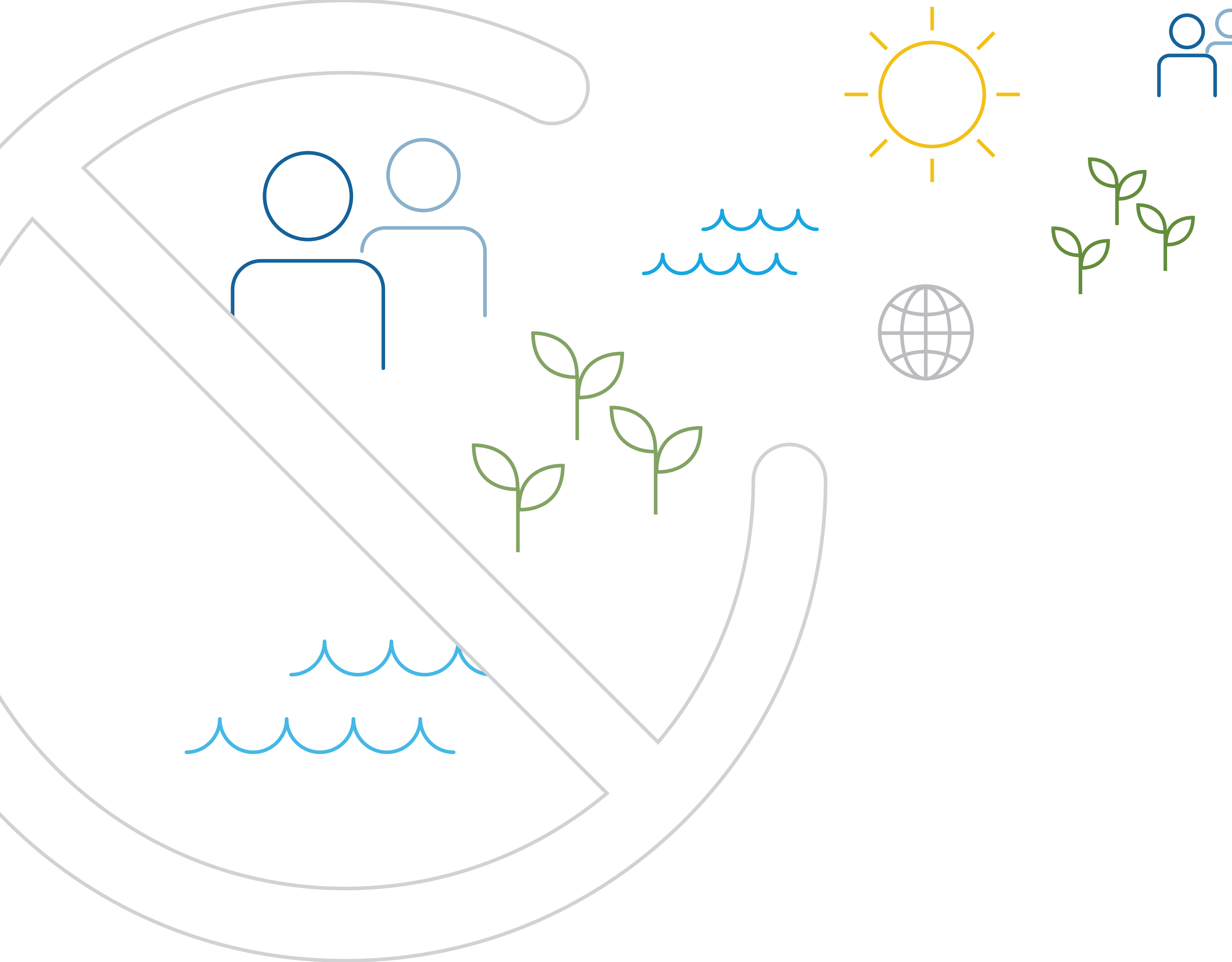
# Moving Beyond Exclusion: Sustainable Investing and Performance



This is a summary of "Sustainable Investing Research Suggests No Performance Penalty," by Jon Hale, Morningstar's head of sustainability research.

For more on the methodology and literature reviewed, see the full study.

**Morningstar's full study covers:**

- 25 papers and articles
- 12 years of sustainable investing research
- Dozens of primary sources
- Thousands of empirical studies

Sustainable investing presents a major growth opportunity for asset managers—according to the Forum for Sustainable and Responsible Investment, $23 trillion in professionally managed assets worldwide currently consider environmental, social, and governance factors in their decisions. A lot of interest is driven by millennials and women, groups that could soon control more than $30 trillion in assets in the U.S. alone. Asset managers are responding to the trend: By mid-2017, more than 1,142 asset managers had signed the U.N.-backed Principles for Responsible Investment.

For more on the investing terms used to discuss sustainability, read our paper 'What's In a Name? The Many Dimensions of Sustainable Investing.'

Yet despite all this, the idea that focusing on sustainability means you sacrifice performance still prevails. The Morningstar research team took a look at the body of academic research and found out that sustainability and performance aren't as mutually exclusive as we've been led to believe.

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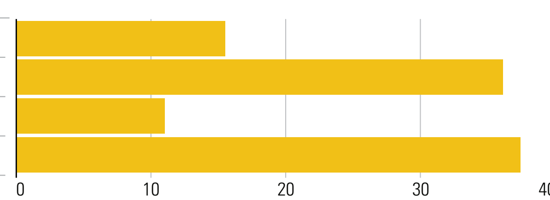
## Is All Sustainable Investing Exclusionary?

The first mutual fund sold as sustainable was the Pax World Fund, introduced in 1971 with a series of exclusionary screens to ensure social responsibility. Since then, other socially responsible and sustainable funds have been introduced, and sustainable investing as a concept has grown to include a host of ESG factors. Investors today have sustainable investing options that go well beyond those early exclusionary screens.

Modern Portfolio Theory suggests that limiting the investment universe, especially because of non-financial factors, results in a less-efficient portfolio. But in fact, the academic research over 25 studies of sustainable and socially responsible funds and portfolios suggests that there's no performance penalty for focusing on sustainability. Consistently, over time, sustainable portfolios perform just as well as conventional portfolios that don't consider ESG factors.

We looked at the outcomes from each of the studies we read and rounded up the performance for each.

| | % |
|---|---|
| Positive | 15.5 |
| Neutral | 36.1 |
| Negative | 11 |
| Mixed | 37.4 |



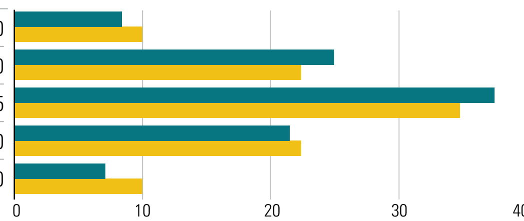

Source: Friede, G., Busch, T., and Bassen, A. 2015. "ESG and Financial Performance: Aggregated Evidence From More Than 2000 Empirical Studies." Journal of Sustainable Finance & Investment, Vol. 5, No. 4, P. 221.

## So, Why the Negative Perception?

Like a lot of long-standing myths, this one does start with a bit of truth. Purely exclusionary screens—broadly screening out "sin stocks," for example—can have negative impact on a portfolio. But today, very few sustainable and socially responsible funds use exclusionary screening so extensively that it severely limits the available universe. Instead, most use holistic consideration of ESG factors in security selection, which is a positive performance factor. In fact, the literature suggests that funds with a focus on ESG inclusion, where an investors uses E, S, and G criteria in their selection process, tend to outperform more often than they underperform—we found more studies with positive outcomes for sustainable investments than negatives outcomes. If anything, sustainable funds and portfolios perform slightly better than conventional ones.

Socially Responsible Funds vs. Fund Universe—Cumulative Morningstar Ratings, 2002–2016

| | Socially Conscious Funds % | Global Fund Universe % |
|---|---|---|
| ★★★★★ | 8.40 | 10 |
| ★★★★ | 25.10 | 22.50 |
| ★★★ | 37.70 | 35 |
| ★★ | 21.60 | 22.50 |
| ★ | 7.10 | 10 |



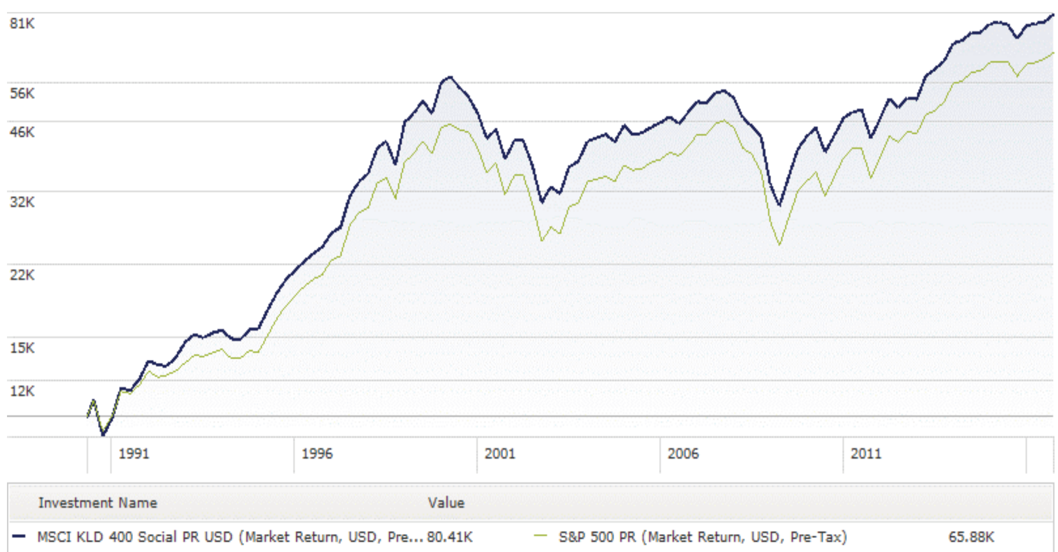

Source: Morningstar Direct. Data as of 9/30/16.

Morningstar ratings of sustainable and socially responsible funds since 2002 favor "socially responsible" funds over the total fund universe.

# What About Index Performance?

Since the oldest sustainable/socially responsible index was created in 1990 (MSCI KLD 400), the performance of those indexes has generally been in line with conventional indexes. In fact, the MSCI KLD 400 outperformed the S&P 500 by a large margin during the 1990s. While it suffered during the dot-com bust beginning in 2000 through 2007, the index makes a strong case that sustainable and socially responsible investments are capable of keeping pace with conventional investments, and are even capable of producing better returns.

MSCI KLD 400 Index vs. S&P 500




| | | MSCI KLD 400 % | S&P 500 % |
|---|---|---|---|
| Since inception | 4/30/1990-9/30/2016 | 8.21 | 7.40 |
| The 1990s | 4/30/1990-12/31/1999 | 19.62 | 16.73 |
| The 2000s | 1/1/2000-12/31/2009 | -2.76 | -2.72 |
| The 2010s | 1/1/2010-9/30/2016 | 9.82 | 10.36 |
| Inception to 2007 peak | 4/30/1990-9/30/2007 | 10.18 | 9.21 |
| 2007 peak to present | 10/1/2007-9/30/2016 | 4.50 | 3.97 |
| Financial crisis bear mkt | 10/1/2007-2/28/2009 | -38.40 | -40.33 |
| Mkt recovery to present | 3/1/2009-9/30/2016 | 15.34 | 15.32 |
| Trailing 10 years | 10/1/2006-9/30/2016 | 5.23 | 4.96 |

Source: Morningstar Direct. Data as of 9/30/16.

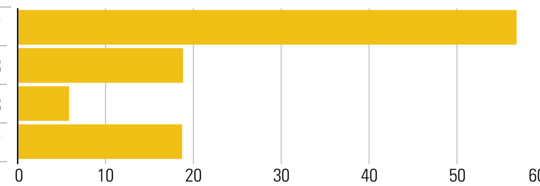
For Morningstar's broadest sustainable index, the Morningstar Global Markets Sustainability Index, we've seen nearly identical returns compared to our Global Markets Index.

## Does it Apply at the Company Level?

With the recent availability of higher-quality company-level ESG data, researchers have been able to dive deeper into the relationship between corporate sustainability practices and financial performance. The studies we reviewed showed a number of positive relationships between companies that employ best practices addressing the ESG factors that face their businesses and financial performance—whether measured in terms of financial results or stock price.

Corporate Sustainability Performance Study Outcomes

| | % |
|---|---|
| Positive | 56.7 |
| Neutral | 18.8 |
| Negative | 5.8 |
| Mixed | 18.7 |




Source: Friede, G., Busch, T., and Bassen, A. 2015. "ESG and financial performance: aggregated evidence from more than 2000 empirical studies." Journal of Sustainable Finance & Investment, Vol. 5, No. 4, P. 221.

## So What's the Lesson?

Over dozens of studies, we found that it's a myth that you have to sacrifice performance for sustainability. But even myths can teach us something; focusing on best-in-class ESG practices in an industry or category, rather than just exclusion, leads to much better results.

For investors and asset managers alike, everything we reviewed suggests that it's possible to achieve both competitive performance and sustainability. Still, this approach continues to develop and evolve. The number of sustainable and socially responsible funds still only accounts for 1–2% of the global fund universe. But based on the research we've studied, we can't find any reason to suggest that sustainability means diminished performance.

## Learn More About the Morningstar Sustainability Rating and the Sustainability Indexes Family

Visit www.morningstar.com/company/sustainability