NEUBERGER | BERMAN

**JONATHAN BAILEY**
Global Head of ESG & Impact Investing

**DANIEL HANSON**
Group Head and Senior Portfolio Manager—U.S. Sustainable Equity

**HENDRIK-JAN BOER**
Group Head and Senior Portfolio Manager—Global Equity

**NIALL O'SULLIVAN**
Chief Investment Officer, Multi Asset Strategies—EMEA

# The Active Foundations of Sustainable Investing

Sustainable investors tend to look for businesses that embody two virtues. The first is a commitment to consider stakeholders, society and the environment in a way that is aligned with long-term, rather than merely short-term, profitability. The second is a sustainable competitive advantage that enables the business to survive multiple cycles and compound its earnings growth over the long term. Most sustainable investors would argue that it is very difficult to find the second without the first.

Sustainable businesses have specific markers relating to these two virtues. Some are relatively easy to quantify, such as a high return on invested capital. Others, such as a strong corporate culture, are less tangible. We believe that analyzing and assessing these less tangible characteristics requires qualitative judgment and close relationships built on long-term shareholder engagement.

In our view, that raises questions about the rising popularity of rules-based, passive sustainable investing products, which mirrors past waves of enthusiasm for market-capitalization, style and factor indices and indexed products. In this paper, we argue that the complex, long-term nature of sustainable investing makes it inherently an active management discipline.

## Executive Summary

**What Is "Sustainable Investing"?**

- A sustainable investment strategy has leadership on material environmental, social and governance (ESG) considerations at the heart of its investment thesis, based on a belief that investing in sustainable business models, practices, products or services can generate outperformance over time.
- The foundations of that belief vary depending on the specifics of each sustainable investment strategy, but one common strategy sees a substantial overlap between sustainability and quality, with strong sustainability characteristics regarded as markers of quality.

**Sustainable Investing Requires Fundamental Judgment**

- Providers of indices and manufacturers of indexed products have sought to replicate their success with market-capitalization, style and factor index products in the ESG and sustainable investing arena.
- We are skeptical of rules-based approaches to sustainable investing: we believe many ESG and sustainability considerations are intangible and need to be assessed with qualitative judgment; where quantitative data does exist it can be patchy and inconsistent; and ESG scores from different agencies exhibit wide divergence due to idiosyncratic data processing.
- At the very least, we believe investors considering an ESG index product should understand that they will be selecting an ESG index investment product provider, an ESG index provider, an ESG index, and an ESG score provider, and that these decisions should be informed by the same level of due diligence they would apply to selecting an active manager.

**Sustainable Investing Requires Engagement and Stewardship**

- Index investment product providers may have a team of stewardship professionals, but we believe it is very difficult to engage deeply and constructively with a company without the detailed knowledge and understanding that comes from being a seasoned analyst of the fundamentals of that company and its wider industry.
- Even if an index provider's stewardship team identify an issue, engage with an issuer's board and management and reach a conclusion, that conclusion could take months or even years to work its way into reported data, ESG scores and index weighting—and, at worst, it may never do so.


Sometimes it can seem that environmental, social and governance (ESG) investing, sustainable investing and impact investing have become victims of their own success.

They have risen to prominence because more and more investors recognize that the way businesses interact with their environment, society and shareholders can be financially material to their bottom lines; because many now look to align their capital with their values; and because some aim for their investments to have an explicit, direct positive impact on the issues they care about.

However, that prominence has attracted often skeptical and sometimes antagonistic scrutiny. We welcome that scrutiny and we believe some of the skepticism is justified. For example, we believe ESG and sustainable investing requires active decision making by both investors and their asset managers, and that attempts to systematize and commoditize these processes can threaten to become an end in themselves, losing sight of the return-maximization objective and making investors think they are getting something they are not—a topic we will return to later.

That said, a lot of the criticism seems to be rooted in a misunderstanding of what asset managers do, and the way they use these terms. So, let's begin by defining what we mean (and what we don't mean) by "sustainable investing."

## What Is “Sustainable Investing”?

We think it is helpful to think in terms of *investment processes* and *investment outcomes*. When asset managers talk about ESG, they usually mean integrating ESG considerations into their investment processes—alongside the traditional considerations that are financially material to the businesses they are analyzing. When they look at an auto manufacturer, they’ll consider its electric vehicle strategy, for example, or how its labor relations compare with its competitors, or the issues associated with its dual voting share structure. Are those “E,” “S” and “G” considerations, or just business considerations? They are both, really, and the labels have evolved over recent years merely to raise their prominence in securities analysis to a level commensurate with their financial materiality.

Impact investing is quite different. This kind of strategy makes investments with the intention to generate positive, measurable social and environmental *outcomes* alongside a market-rate financial return (“non-concessionary impact investing”), or as a priority over a market-rate return (“concessionary impact investing”). For example, an impact investor would invest in a wind turbine manufacturer, or a social enterprise, primarily because of its product’s positive environmental or social impact.

Sustainable investing sits somewhere between the two. Like ESG-integrated investing, this kind of strategy typically seeks to achieve a financial goal. But like impact investing, it goes beyond *process* to seek sustainability-related *outcomes* by investing in high-quality issuers that have sustainable business models, practices, products or services. A sustainable investment strategy has leadership on material ESG considerations at the heart of its investment thesis, based on a belief that investing in sustainable business models, practices, products or services can generate outperformance over time.

## What Does That Mean in Practice?

Why would an investor believe that a sustainable business model should outperform over time? The answer to this question will vary depending on the specifics of a strategy and how the investor sees ESG considerations playing a part in that strategy.

One common sustainable investing strategy shares a lot of its ideas with quality investing. In this way of thinking, strong sustainability characteristics are seen as markers of quality alongside traditional markers such as a sustainable competitive advantage in the market, high return on invested capital, high free cash flow and a conservative capital structure. Strong sustainability characteristics may even be considered precursors of those traditional markers of quality.

To put it another way, this approach to sustainable investing conceives of a quality business as a nexus of competitive and financial durability, governance that embodies and aligns with a strong corporate culture, and environmental and social sustainability.

**(1) Competitive and Financial Durability.** A company that responds to an unmet market need in a way that is sufficiently differentiated to sustain a competitive advantage—what some investors call a company’s “moat”—can achieve lasting pricing power. That enables the compounding of earnings growth and the generation of free cash flow which, in turn, enables constant investment in that competitive advantage, with minimal borrowing, throughout the business cycle.

**(2) Governance and Culture.** This is about both management and shareholders. A business with a clear long-term purpose and mission that is embedded in its culture is more likely to sustain itself, in this view. Shareholders that understand this purpose know what to expect from company performance through all stages of strategy implementation and the capital cycle, which means they stay invested through those cycles—and, where necessary, engage as genuine business owners to keep management focused on the mission.

**(3) Environmental and Social Sustainability.** Sustainable investors tend to believe that the companies most likely to generate long-term value for shareholders are those that focus on the impact they have on a wider group of stakeholders. They believe that successful businesses look to grow the pie for all stakeholders rather than accepting the size of the pie and trying to cut the biggest slice for their shareholders alone. At its widest, this stakeholder group might be considered to include all of society and the environment itself; but the first and foremost stakeholders, in terms of materiality, are the company’s customers and employees.

A business can generate short-term profits for shareholders despite an adversarial relationship with its customers—for example, if those customers face poor service but high switching costs—but a moat built on making life difficult for customers is not likely to confer a sustainable competitive advantage. Instead, sustainable investors tend to see long-term success as being built on enhancing productivity, quality and service for the benefit of both customers and shareholders.

A business can also generate short-term profits for shareholders by providing the bare minimum of pay and conditions for its employees. But a sustainable investor sees long-term value in building a reputation for being a best-in-class employer, especially in an environment like today's, with its growing labor shortages. Employees who do not feel valued and invested-in are unlikely to feel loyalty to their company, let alone part of a firm-wide culture and mission—one of the things both sustainable and quality investors consider key to long-term success.

Finally, a business can generate short-term profits for shareholders without any regard for the environments and communities in which it operates. Sustainable investors and long-term shareholders tend to believe in the ultimate materiality of a "social license to operate," however. That is why they tend to look for companies that are known for providing skilled employment opportunities and environmentally sustainable economic growth in their local communities.

Does this approach favor particular sectors or industry groups? Marginally, yes. It is less likely to favor "commodity" businesses that rely heavily on tangible assets, as these are subject to high competitive pressures and cyclicality. Instead, it tends to favor companies that can sustain high returns on invested capital because they rely on intangible assets, such as intellectual property and brand, to build a moat against competition. "Commodity" businesses may be managed well, and be good employers and good corporate citizens, but in the end, they are involved in a zero-sum game—rather than earning a social license to operate by growing the pie for everyone, it's about grabbing the biggest possible slice of the pie for the short time it takes for another business to figure out how to grab it back again. This is why many sustainable investors naturally gravitate to higher-quality, less cyclical, asset-light, growth-compounding sectors.

That said, while high-quality businesses with compounding earnings growth often look more expensive than they really are, valuation matters for any investment strategy. The run of extraordinary outperformance by longer-duration growth stocks into 2021, and its reversal in 2022, was a reminder of the importance of valuation discipline and, for sustainable investors, a reminder of how it can pay to maintain a diverse investment universe and seek opportunity in some of the less obvious places and sectors.

## Sustainable Investing Requires Fundamental Judgment

We think all successful investment approaches have a coherent philosophy and a clear process for executing on it, and sustainable investing is no exception. Does it follow that passive, rules-based sustainable investing can be successful?

We think this is an increasingly important question, as index providers and manufacturers of passive investing products seek to replicate their success with market-capitalization, style and factor index products in the ESG and sustainable investing arena. These moves are being encouraged by some regulators, who see the availability of benchmarks and index investing solutions as an important enabler for broader investor engagement in sustainability.

We are skeptical, however, and believe sustainable investing is intrinsically an active discipline.

A systematic, rules-based investment strategy designed to harvest a factor based on traditional financial metrics, such as value, might rank the universe of stocks by price-to-book (P/B) or price-to-earnings (P/E) ratio. But that can be a very blunt instrument. Knowing a company's book value on a balance sheet—without any forward-looking view based on fundamental research—doesn't tell you much about the quality of the assets that constitute that book value. Knowing the value of a company's earnings doesn't give you a sense of how much is accrued earnings, or subject to some other aggressive accounting distortion. And a low valuation does not tell you whether a stock is an undervalued bargain or a business whose profits are about to decline.

Similarly, we have a litany of data, metrics and scorecards in the ESG and sustainability world to set alongside traditional financial data like book value and earnings—some of which we generate internally, some of which come from respected third parties. To understand a company's employee satisfaction and corporate culture, for example, we have filings like EEO-1 reports, and even some "big data"

such as Glassdoor employer ratings. Those data can be tremendously helpful, but without judgment, fundamental research and detailed knowledge of a company, its management, its industry and its customers, they can be even more misleading than a blunt P/B or P/E ratio.

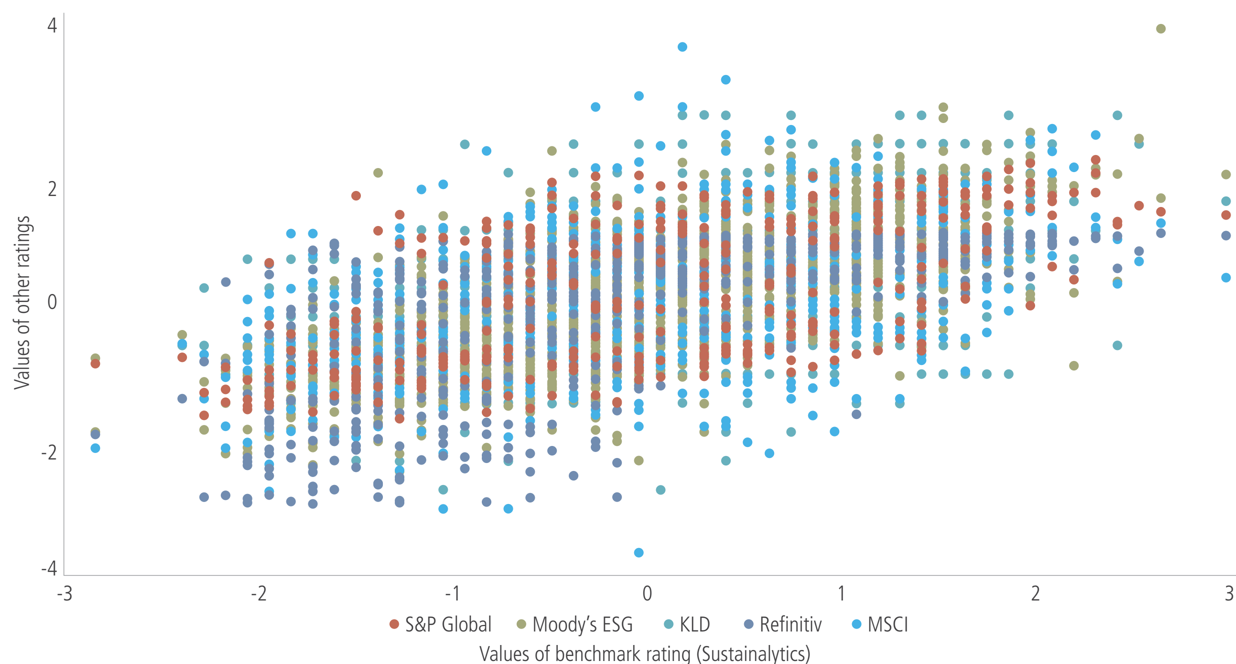
Moreover, there are discrepancies in many ESG-related data that we simply do not see in traditional financial metrics. Two value factor indices that weight the same equity universe by P/E ratio are likely to look very similar. The same cannot be said for two ESG indices that both weight by an ostensibly similar ESG score—even though they ultimately draw on the same set of reported data, just as the value factor index providers draw on the same reported earnings and market price data. Several surveys have found that research companies' ESG scores for the same company can vary widely, with almost zero correlation.

That's partly because ESG data is often patchy and incomplete, requiring those who generate ESG scores to fill the gaps with modelled inputs. Scorers also process the reported data in different ways to generate their ESG scores for individual issuers, adding another important layer of subjective judgment to any rules-based investment approach that uses them. The frequency with which data inputs are updated can vary, for example; judgments about the relative importance and weighting of particular considerations and metrics vary; human biases are involved when turning underlying metrics into ESG scores; and scores are often relative, and therefore the choice of constituents in peer sets can affect outputs for individual issuers.

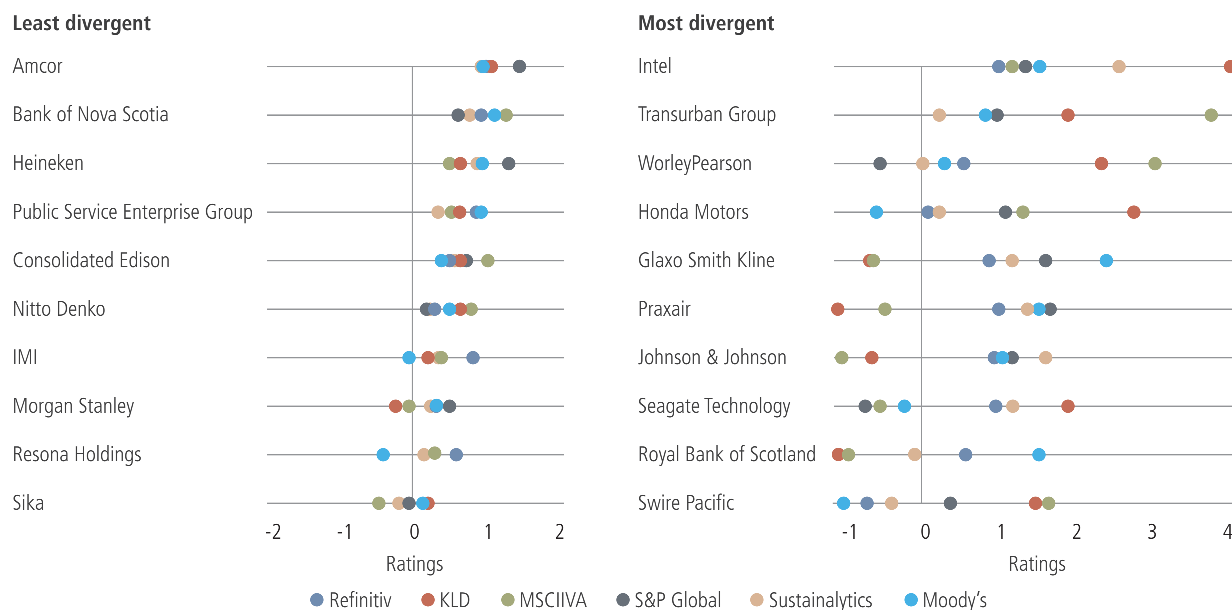
The difference this can make is illustrated in figure 1. The first chart plots the ESG scores awarded by five research companies to 924 issuers against the score they have received from a sixth research company chosen as a benchmark. Wide dispersion suggests that these six companies score these issuers very differently. The second chart shows the 10 issuers with the least and most divergent ESG scores from the six ESG research companies, and again it reveals that the same issuer can receive ESG scores that diverge by more than three notches. Even among the 10 issuers with least divergent scores, four are given scores that range from negative to positive.

**FIGURE 1. DIFFERENT ESG RESEARCH COMPANIES AWARD VERY DIFFERENT SCORES TO THE SAME ISSUERS**

ESG scores awarded by five companies to 924 issuers, benchmarked against Sustainalytics' scores for the same issuers



Issuers with the 10 least and 10 most divergent ESG scores from the six ESG research companies




Source: Top: Florian Berg, Julian F. Kölbel, Roberto Rigobon, "Aggregate Confusion: The Divergence of ESG Ratings" (April 2022). Bottom: Florian Berg, "Why Do ESG Ratings Vary So Widely—and How Can Investors Make Sense of Them?", *The Wall Street Journal* (November 2022). The different rating scales of the six research companies were normalized for comparison, by subtracting the mean and dividing it by its standard deviation.

It would be problematic were credit rating agencies' ratings for individual companies to diverge to this extent. But this is a feature of ESG scoring, not a bug.

One of the most important sources of divergence is variation in judgment about the relative importance and weighting of different categories of data—how should "Corruption" and "Product Safety" be weighted relative to one another, for example? Active managers who use third-party ESG scores will have different views on this, so for them a diversity of options can be helpful. Indeed, if we looked at ESG scores generated in-house by active managers themselves, we would almost certainly see a similar dispersion of views, simply because everyone faces the same challenges of receiving patchy and incomplete data and deciding how best to process it for their individual needs.

This feature of ESG scoring severely limits its suitability as a basis for systematic, rules-based investment approaches, however: investors can systematically apply rules based on an individual provider's scores, but those rules cannot replicate a genuine, objective investment factor in the way that rules based on value metrics can replicate the value factor. This issue doesn't exist for an active manager. When it faces patchy and inconsistent data, it will try to fill the gaps with both modeling and fundamental research-backed judgment, rather than modeling alone; its investment decisions will be informed, but not constrained, by its data-integration processes; and its ultimate end is to make the best possible investment decisions—an active manager simply isn't concerned about identifying an objective ESG or sustainable investment factor.

That is why we are skeptical that systematic, rules-based, passive approaches to ESG-integration, and especially to sustainable investing, can be as successful as active approaches. At the very least, we believe investors considering an ESG index product should understand that they will be selecting an ESG index-investment product provider, an ESG index provider, an ESG index and an ESG score provider, and that these decisions should be informed by the same level of due diligence they would apply to selecting an active manager. What exactly is the index aiming to represent, and does that align with the investors' objectives? What data does it draw upon, and what is the quality of that data? To what extent is the indexing process reliant on ESG scores (and therefore the score provider's philosophies, methods and processes) over reported data? And if ESG scores predominate, do the methodologies

and processes of both the ESG index provider and the ESG score provider stand up to scrutiny, and do their philosophies align with the investor's?

In short, we regard ESG index products as too active to be passive, but too passive to be sustainable. There are many flavors of ESG, sustainable and climate-related index investing products, and some are more sophisticated than others, but ultimately they are all restricted to following incomplete, backward-looking data and rigid rules to a far greater degree than any active manager needs to be.

## Sustainable Investing Requires Engagement and Stewardship

Furthermore, index investment products cannot offer what we consider to be an essential pillar of sustainable investing: genuinely engaged ownership and stewardship of portfolio companies.

Providers of index investment products may well have a team of stewardship professionals that engage with companies—indeed, they often argue that this is a necessity for passive investors, who may have no choice but to hold every company in the index. However, we believe it is very difficult to engage deeply and constructively with a company without the detailed knowledge and understanding that comes from being a seasoned analyst of the fundamentals of that company and its wider industry. Even if an index provider's stewardship team identify an issue, engage with an issuer's board and management and reach a conclusion, that conclusion could take months or even years to work its way into reported data, ESG scores and index weighting—and, at worst, it may never do so.

By contrast, we can point to examples of constructive engagement yielding positive results. Importantly, our focus as a firm is heavily geared toward encouraging best practice in communication and disclosure. We rarely tell company boards or management what they should be doing at the operating level. Instead we want them to report the right things in a standardized way so that we and other active managers can assess their strategy and progress, recognize their leadership in the market—and, if necessary, hold them to that strategy.

That doesn't mean that we don't sometimes meet resistance, however, particularly when we are looking ahead and anticipating reporting practices that may not be widely adopted today, but that we expect will become the standard in future. We began engaging with companies to advocate the adoption of Science Based Targets for emissions reporting back in 2018, for example, and in many cases that has been a multi-year effort that depends upon our being a long-term shareholder who nurtures deep relationships with board and management. Right now, an emerging issue we are engaging on quite widely is the regulation and ethical deployment of technology, from social media to artificial intelligence—we want to clarify how management is thinking about these issues and how they might communicate that to shareholders. We are skeptical that any of this can be achieved outside the environment of active management.

**Engagement Works: 2022 Highlights from NB Votes**

*Through our NB Votes initiative, we publish our vote intentions in advance of select shareholder meetings, with a focus on companies where our clients have significant economic exposure.*

**https://www.nb.com/en/us/esg/nb-votes**

| Company | Issue | Why Is It Material? | Action | Result |
|---|---|---|---|---|
| **Bunzl Plc** | No independent directors overseeing material ESG matters, despite sustainable supply chains being a strategic objective. | Building sustainable supply chains and helping reduce its customers' carbon footprints are key strategic objectives at Bunzl, which makes products for a variety of industries, from grocery to healthcare. | NB engaged with the company and supported the reelection of the board chair following commitment to address this issue at the next board meeting. | Bunzl's board formalized ESG oversight within a designated board-level committee. |
| **General Motors Co (U.S.)** | Executive compensation insufficiently aligned with performance toward the company's decarbonization and electric vehicle (EV) objectives. | With electric vehicles now a cornerstone of GM's long-term strategy, we believed there was an opportunity to tie compensation more explicitly to the company's EV objectives. | Multiple engagements and a letter to the board. | Various improvements, including new EV-related metrics comprising 15% of GM's 2022 long-term incentive plan (LTIP); and enhanced disclosure of factors used to evaluate each executive. |
| **Texas Instruments** | While generally a high-quality company with good disclosure practices, the firm lagged on Know Your Customer (KYC) due diligence and disclosure, and could better communicate how its practices extend to the downstream value chain. | KYC due diligence is increasingly important given current scrutiny around the ethical use of technology. | A shareholder proposal at the 2023 AGM highlighted these emerging risks; we engaged with both the company and the filer, voicing our support of advanced KYC disclosures. | We believe management is now evaluating the value of potential processes and disclosures that would acknowledge the importance of advanced KYC governance and communication, and we continue to monitor progress. |
| **Yamaha Corp (Japan)** | Yamaha included ambitious targets for sourcing sustainable wood for musical instruments in its Mid-Term Plan, but few details on how it planned to achieve those targets or its long-term goal of 100% sustainable sourcing; also, its disclosures are not yet aligned with globally recognized ESG standards. | Long-term, scarcity and the rising cost of timber, driven in part by climate change and illegal logging, presents a challenge to Yamaha's ability to maintain scale and a strong brand reputation. | We recommended increasing specificity on the sustainable sourcing initiative, with more detail on how to achieve the firm's goal of 100% sustainable procurement; and adopting standard ESG disclosures. | Yamaha set a higher, 75% target for sustainable procurement in its latest Mid-Term Plan, and added detail on initiatives required to meet that target—chiefly, a third-party accreditation system to lower costs for sustainable suppliers; we continue to advocate for standard ESG disclosures. |

## Conclusion: Sustainable Investing Needs to Be Holistic and Active

Sustainable investors look not only for businesses that can build a competitive moat that enables them to compound earnings growth for the long term, and not only for businesses that align their commitments to stakeholders with long-term profitability. They look for businesses that embody both of those virtues. It is possible for businesses to have one without the other, but most sustainable investors regard these as rare exceptions to the rule that sustainable social, environmental and governance practices help to nurture sustainable profits.

Sustainable businesses have specific markers. Some of those are relatively easy to quantify: a high return on invested capital, for example; high levels of free cash flow; strong balance sheets; low carbon emissions relative to peer group, infrequent social controversies or labor disputes. Others are less tangible and require qualitative judgment: does a company have a truly sustainable competitive advantage, and a strong corporate culture? Then there are the intangibles of the sustainable investment process itself: how to deal with patchy and inconsistent data, for example, or how to weight the relative importance of different sustainability considerations. In our view, these intangibles, together with the tendency of high-quality, growth-compounding companies to trade at premium valuations, make it very difficult to identify fairly valued sustainable companies with a systematic, rules-based, backward-looking approach to investment.

Sustainable investing is a complex discipline. We believe that makes it inherently an active management discipline.

This material is provided for informational purposes only and nothing herein constitutes investment, legal, accounting or tax advice. This material is general in nature and is not directed to any category of investors and should not be regarded as individualized, a recommendation, investment advice or a suggestion to engage in or refrain from any investment-related course of action. Investment decisions and the appropriateness of this material should be made based on an investor's individual objectives and circumstances and in consultation with his or her advisors. Information is obtained from sources deemed reliable, but there is no representation or warranty as to its accuracy, completeness or reliability. All information is current as of the date of this material and is subject to change without notice. Any views or opinions expressed may not reflect those of the firm as a whole. Neuberger Berman products and services may not be available in all jurisdictions or to all client types.

Investing entails risks, including possible loss of principal. Investments in hedge funds and private equity are speculative and involve a higher degree of risk than more traditional investments. Investments in hedge funds and private equity are intended for sophisticated investors only. Indexes are unmanaged and are not available for direct investment. **Past performance is no guarantee of future results.**

This material is being issued on a limited basis through various global subsidiaries and affiliates of Neuberger Berman Group LLC. Please visit www.nb.com/disclosure-global-communications for the specific entities and jurisdictional limitations and restrictions.

The "Neuberger Berman" name and logo are registered service marks of Neuberger Berman Group LLC.

**Neuberger Berman**
1290 Avenue of the Americas
New York, NY 10104-0001

Y0208 09/23 1533710 ©2023 Neuberger Berman Group LLC. All rights reserved.

**www.nb.com**