Responsible Investing:

Socially responsible investing (SRI) has seen increasing interest over the past decade as endowments, foundations, institutions and individual investors have sought to align their capital with personal values and goals. This interest and investors' increased awareness of global climate change, demographics, resource scarcity, and generational trends are some of the reasons that have brought responsible investing from a niche market and made it one of the fastest growing investment areas of asset management. According to the 2014 US Sustainable, Responsible and Impact Investing Trends report, there were $6.57 trillion of assets in SRI strategies at the start of 2014 in the United States, which is up from about $2 trillion fifteen years ago.

The responsible investing landscape has been evolving over the past few decades. Early adopters of the philosophy typically used a values-based approach. This type of investing traditionally has focused on negative or exclusionary screens based on religious, environmental and ethical beliefs. These strategies may exclude undesired exposures to companies in industries such as tobacco, alcohol, gambling, nuclear power, fossil fuels, etc. As responsible investing has evolved, investors have moved away from solely focusing on negative screens and have increasingly used Environmental, Social, and Governance (ESG) criteria to evaluate companies based on positive attributes.

What is responsible investing?

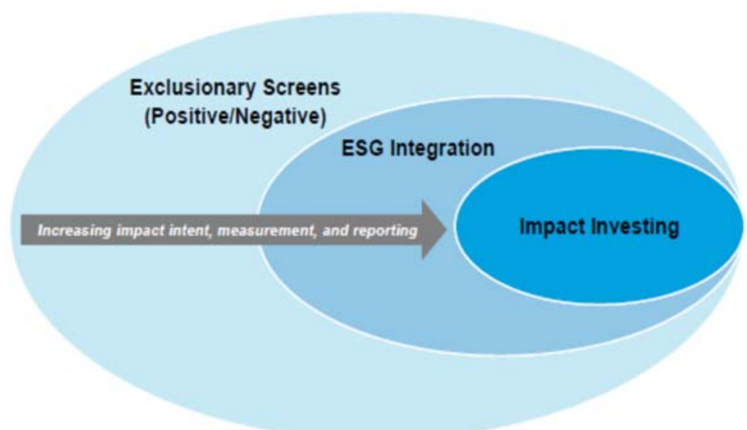
Responsible investors utilize ESG criteria in their investment decision making process to select securities that have a positive societal and environmental impact while generating competitive returns. The term "responsible investing" does not mean more "traditional" strategies invest in an irresponsible manner. However, traditional managers will place more emphasis on financial factors in the investment decision making process and in meeting long-term financial needs.

Terminology in the responsible investing space can be very confusing as terms have often been used interchangeably, despite major differences in strategies. Part of the issue is investment managers are using different terms as they try to differentiate their product from other strategies. Common terms include socially responsible, ESG, values-based, thematic, double or triple bottom line and impact investing. For the purposes of this paper, the table below outlines definitions of types of SRI strategies that will be used. It is important to highlight that there is a continuum of responsible investing strategies and they are not as easily placed into buckets as listed below. For instance, managers will differ in how they conduct and integrate ESG research, the degree to which they engage corporations on ESG issues and the determination of screening criteria.

	Values-Based	ESG Integration	Thematic	Impact
Priorities	• Screen by interests and values. Avoid investments in potentially "objectionable" companies and industries • Not actively seeking environmental and social impact	• Identify managers that target companies whose approach to environmental, social or governance issues creates value differentiation	• Focus on themes and sectors targeting specific environmental or social changes	• Participate in investment funds that focus on providing capital directly to private enterprises structured to effect positive social or environmental change
Characteristics	• Public equity and debt • Differentiated by screening criteria and degree of shareholder advocacy	• Public equity and debt • Differentiated by manner of ESG integration and degree of shareholder advocacy	• Public equity and debt • Differentiated by industry or sector focus	• Private equity & debt • May have investor restrictions • Differentiated by integration of financial thesis and mission • Might offer social and/or environmental reporting
Investment Examples	• A mutual fund that excludes tobacco or firearms companies	• A mutual fund that includes ESG analysis as part of its investment process	• An ETF composed of clean energy stocks	• A private equity fund focused on emerging consumers or project-level renewable energy investment

Source: Morgan Stanley

Screening for positive or negative company attributes is a key part of responsible investing. As noted above, historically many strategies have focused on exclusionary screens. More recently, managers have emphasized integrating research on ESG issues into their fundamental analysis. These managers look for companies with positive ratings on ESG issues. The graph to the right is a representation of how the level of impact intent and measurement can increase across responsible investing strategies.



Source: "Impact Investing within the Context of Sustainable and Responsible Investing", World Economic Forum, September 2014.

The table below lists a sample of ESG factors that can be incorporated into the investment process. For instance, investors will rate companies on how environmentally friendly they are or how well they disclose data on ESG issues.

ESG Factors

Environmental	Social	Governance
•Toxic emissions and waste •Water management •Regulatory compliance •Environmental disclosure and transparency •Occupational/workplace safety •Eco-efficiency	•Product safety and quality •Labor management and relations •Workforce diversity •Work/life balance •Employee retention and training •Employee benefits and compensation	•Board structure and independence •Business ethics and competitive behavior •Management structure •Compensation policies •Governance guidelines •Transparency •Disclosure

Shareholder advocacy is another way some investment managers use their holdings in a company to foster social, environmental and governance change and advise companies to adopt sustainable business models. Investors may engage company management to try and influence positive change on ESG issues such as adding environmental disclosures to financial statements or diversifying their workplace. Many investment managers will have a policy on responsible voting of proxies and not blindly siding with company management. Annual proxies are used by companies for approval of board of directors, compensation and a number of other issues.

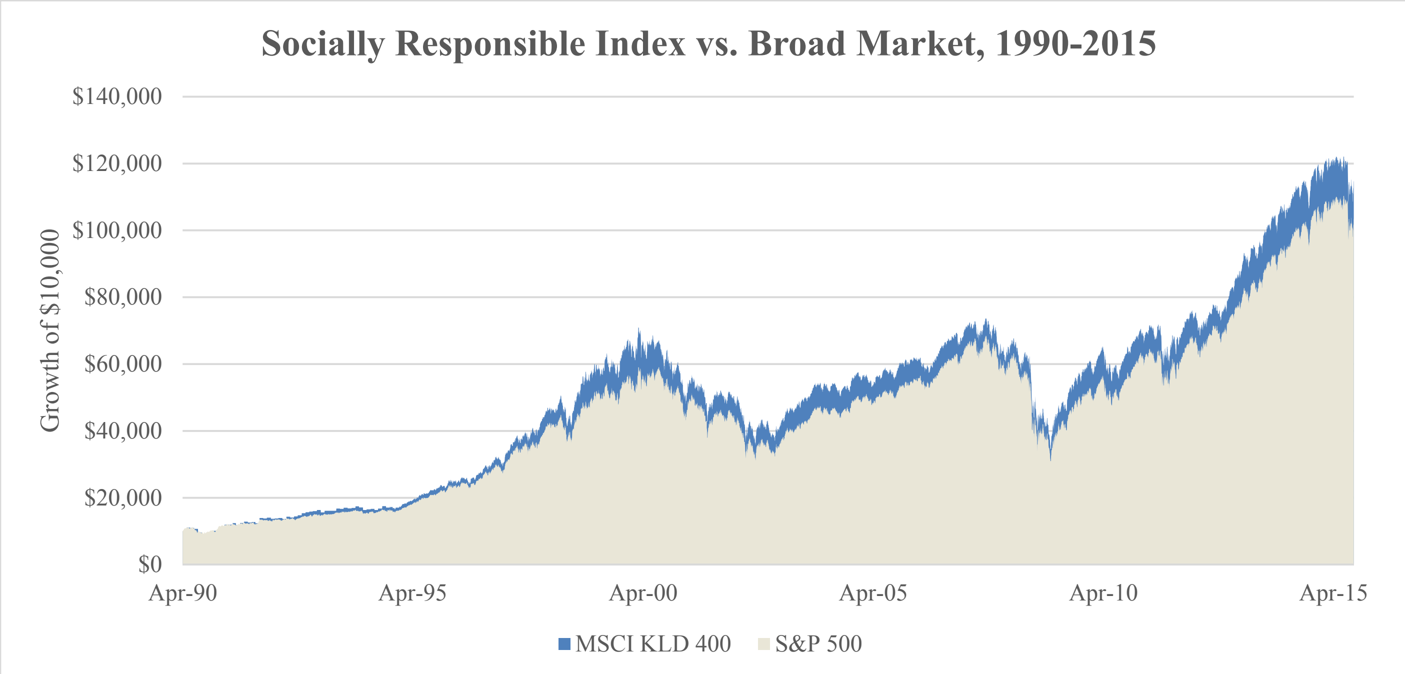
In 2006, the United Nations along with financial institutions created the Principles for Responsible Investment to formalize ESG standards and goals. There are currently more than 1,400 signatories from over 50 countries that manage $59 trillion of assets. Signatories have agreed to incorporate the principles into their investment process.

United Nations Principles for Responsible Investment

1) We will incorporate ESG issues into investment analysis and decision-making processes.
2) We will be active owners and incorporate ESG issues into our ownership policies and practices.
3) We will seek appropriate disclosure on ESG issues by the entities in which we invest.
4) We will promote acceptance and implementation of the Principles within the investment industry.
5) We will work together to enhance our effectiveness in implementing the Principles.
6) We will each report on our activities and progress towards implementing the Principles.

Does responsible investing lower returns?

A common concern or misperception of investors is that responsible investing strategies will have lower returns; however, this is not the case. There have been numerous studies over the past few years that have shown responsible investing does not inherently mean lower returns. In fact, many studies have shown that responsible investing may actually provide better risk-adjusted returns. Deutsche Bank and Mercer, two large financial service firms, conducted reviews of dozens of academic studies, in 2012 and 2009 respectively, and found that companies with strong ESG characteristics were positively correlated to lower cost of capital, market-based outperformance and accounting-based outperformance. In simple terms, companies with strong ESG characteristics tended to have better financial statements which lead to stronger stock market performance. Below is a graph that shows the returns of the oldest socially responsible index versus the broad market over the past 25 years. The socially responsible index actually outperformed over that time-period. Research in this space will surely continue similar to the ongoing “active versus passive” debate. However, it is safe to say that there is not negative drag from responsible investing.



Source: Morningstar

Attributes of high quality companies such as stable earnings, strong management teams, lower cost of capital and lower debt tend to correlate with ESG factors. Companies may incur higher litigation, regulatory and remediation costs if they have substandard performance on ESG issues. Since ESG is correlated with quality, these managers may underperform near term in an environment where risk taking is rewarded, similar to traditional high quality managers. However, over the long-term, high quality companies tend to provide a better risk-adjusted return. Additionally, some SRI managers may underweight or overweight certain sectors such as energy due to their philosophy. In the short-term, if certain sectors are strongly outperforming or underperforming these managers may have investment performance out of sync with the broad market. Ultimately, the performance of an active fund will be determined by the skill, process and stock-picking of the manager.

Challenges for the space:

Despite progress in the responsible investing space, there are still implementation challenges. While there are more investment options for responsible investing than a decade ago, there is still a limited universe of managers that run specific SRI strategies, especially those with a longer track-record. In addition, creating a diversified portfolio made entirely from SRI strategies can be difficult. There are many options in large cap equities but there are fewer managers in other categories such as small cap, international, emerging markets, fixed income, etc.

Another challenge for the segment is the measurement of impact and reporting of ESG issues. Financial institutions and corporations are working together to provide more transparency for investors on ESG topics. Corporations have found that improving on ESG issues not only improves their public image but can have a positive impact on financial performance. By utilizing their resources more efficiently and incorporating renewable energy sources, they are able to reduce expenses. While many companies see the benefit of improving on ESG issues, it can be difficult and expensive to implement. Companies are trying to publish more ESG metrics such as carbon footprint in their financial statements for transparency; however, currently many companies have limited disclosures as they can be difficult to quantify. Data on ESG factors and company ratings is becoming more accessible as there are more research firms providing ESG ratings but this research area is still in its infancy.

How we utilize ESG at SilverOak

At SilverOak, our recommended IQSS™ (Investment Quality Scoring System ™) managers look for high quality companies with earnings growth and strong prospects. While most of our managers look for quality factors that are correlated with ESG factors, not all of the managers formally incorporate ESG into their fundamental research. However, several of our managers have signed the UNPRI and do utilize ESG factors in their process. SilverOak has developed and will continue to refine a responsible investing framework that integrates ESG and IQSS™ strategies for those clients that are interested in such a portfolio. We will continue to monitor the responsible investing segment for new research and strategies. With some of the largest managers of capital in the world focusing resources into growing their responsible investing research and product offerings, the segment will see continual change and will require ongoing due diligence.

SilverOak has a long history of manager due diligence and investment management. Our analytical process and knowledge in selecting the best mangers for our clients allows us to team with managers that have strong responsible investing histories in advancing research and positive societal change in the industry.

Disclaimer:

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Investment decisions should be made based on an investor's specific circumstances taking into account items such as, risk tolerance, time horizon and goals and objectives. All investments have some level of risk associated with them and past performance is no guarantee of future success.