ON OUR MINDS

ESG Sustainability: A Free Lunch for Investors

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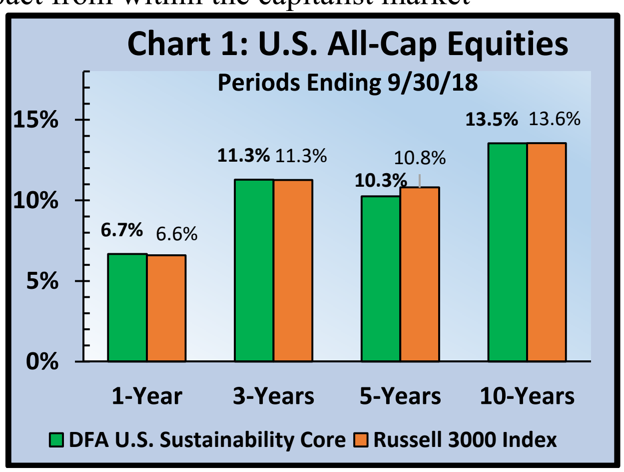
The line between investing and philanthropy has always been a bit blurry; the former is about using money to help oneself, while the latter is about using money to help others – but there has always been some overlap. Investment strategies focused on environmental, social, and governance (ESG) themes aim to produce financial gain while still healing the planet, feeding the hungry, housing the homeless, providing clean energy, and more.

> *All over the country, I've seen it the same –*
> *Nobody's winning at this kind of game.*
> *We've got to do better, it's time to begin,*
> *And you know the answers must come from within.*
> *So come on and have a free lunch.*[1]

The old patterns wouldn't produce meaningful change; standard portfolios and mindless proxy voting won't win better corporate governance nor target investment dollars toward the public good. Today we have the ability to do better; Eastern Bank Wealth Management has the requisite tools to help investors' dollars make a positive impact from within the capitalist market economy. It's a free lunch: For the first time, investors can choose portfolios designed to accomplish these laudable goals without sacrificing financial returns. Charts 1, 2, and 3 show the total return of representative broadly diversified ESG index funds against those of traditional index funds over the past ten years. For the two domestic funds, performance has been nearly identical to their respective non-ESG benchmarks. For international funds, we see small variances, but they are primarily in favor of the ESG funds; doing good turns out to do very well.



Source: Dimensional Funds Advisors

Armed with a growing data demonstrating that ESG investing does not have to impair performance, individual investors and institutions are increasingly demanding that their money be invested in ways that are congruent with their own moral or ethical values. Some studies have found that as much as one in six new investment dollars is being targeted to ESG strategies.

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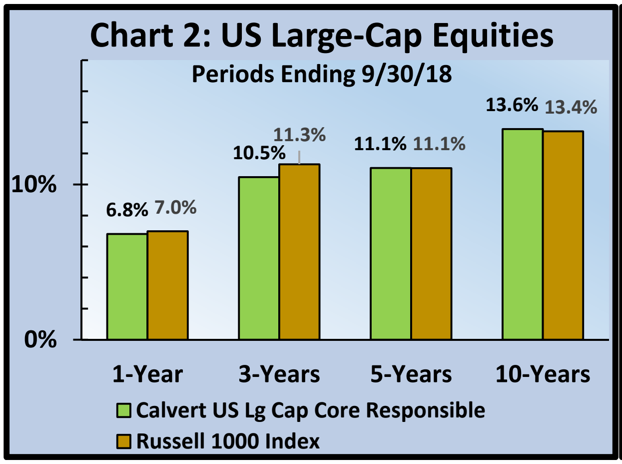
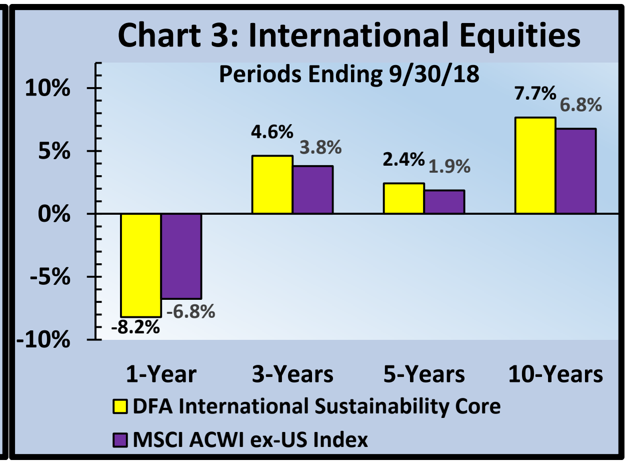
[1] "Free Ride," by Dan Hartman, performed by the Edgar Winter Group, 1973.



Source: Calvert Research & Management



Source: Dimensional Funds Advisors

Most ESG strategies screen securities for various "toxic" elements such as tobacco, adult entertainment, land mines, fossil fuels, and human rights abuses.[2] The fund managers then divest these holdings and rebalance the remaining securities to produce comparable investment returns. But for investors who want to invest according to their values, that's not good enough. Selling shares in an oil company (for example) doesn't actually change anything: The shares still exist, but now they would be owned by someone with a different perspective on fossil fuel extraction.[3]

Eastern Bank Wealth Management has offered ESG portfolios for many years, and we are constantly refining our methodology to remain at the forefront of industry best practices. Today, we think any ESG strategy needs to stand on three separate pillars:

- **Divestment (don't do evil).** There are some companies and some industries that we cannot support under any circumstances; this may be because of products they sell (such as tobacco) or because of their business practices (such as human rights abusers).

- **Engagement (activism through ownership).** In many industries – including energy, technology, health care, and others – we can combine our voices with those of other shareholders to demand change of corporate behavior.

- **Positive impact (be the change).** Opportunities exist to invest in companies that focus on sustainable and responsible activity across a wide range of industries.

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[2] This group also includes funds that aim to promote a specific broad-based theme, such as "gender lens" funds that focus on companies with high proportions of women in senior leadership positions, or funds that tie investment policies to religious tenets. However, these types of funds primarily implement their strategies by screening out companies that don't meet their preferred criteria.

[3] Imagine this thought experiment: If climate-change activists sold their oil company holdings, what would happen at the next shareholder meeting? Instead of a large group of owners telling management to rethink its reliance on oil, the new shareholders would be enthusiastically encouraging management to drill more, extract more, and pollute more, all in the name of growing profits. Mere divestment is a feel-good mirage.

Our new Sustainability strategy is an important evolution from our previous ESG model, and it embraces all three of these key pillars. We have reconsidered every aspect of our methodology and partnered with industry leaders to give our clients a comprehensive means of using their money to effect positive change in the world, while still protecting and enhancing their own financial futures.

Divestment

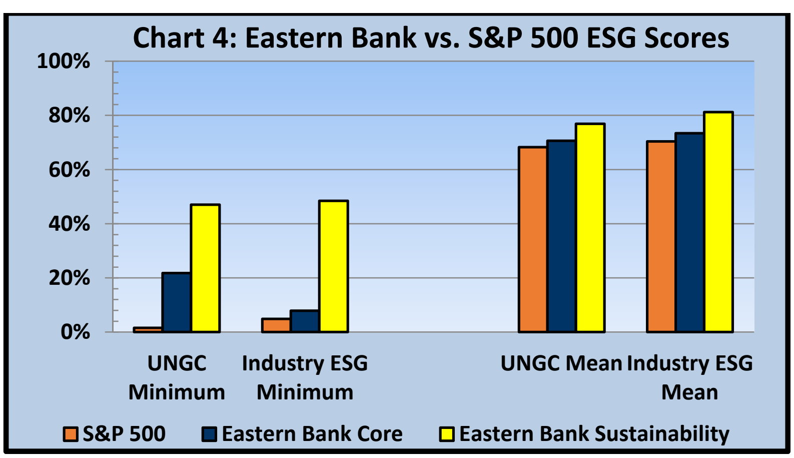
We have partnered with Arabesque, a global provider of ESG database solutions, to identify which securities should be divested from traditional portfolios. We use two filters to weed out companies based on both universal and industry-specific factors.

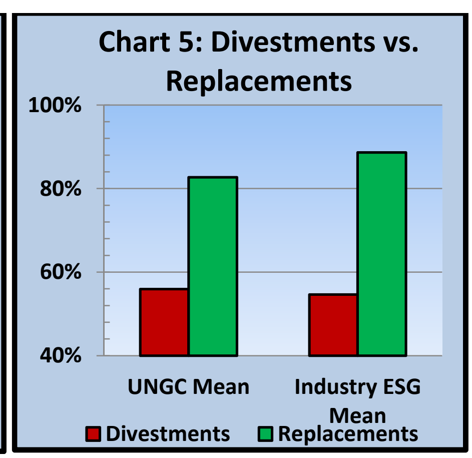
- First, Arabesque scores more than 6,000 companies worldwide on their adherence to the United Nations Global Compact (UNGC); this document identifies ten core principles including human rights, labor relations, environmental stewardship, antidiscrimination, and sustainable technology.

- Second, Arabesque also looks at 12 quantifiable metrics that vary in importance from industry to industry; these include regulatory risk, resource efficiency, governance, disclosure, and environmental data.

We then divest companies that fall in the bottom 20% of either screen, and replace them with similar companies that score more highly. In doing so, we eliminate "bad actors" but not entire sectors of the economy. We would rather own well-run companies even in "bad" industries when doing so gives us an opportunity to influence management and therefore future activity.

The result of our divestment program is that our Sustainability portfolio's overall ESG scores are measurably above those of our Core portfolio, as shown in Chart 4; the divestments mean that our worst-scoring companies are significantly better corporate citizens than those in the traditional portfolio or in the S&P 500 index. Further, as shown in Chart 5, the "replacement" companies score much more highly on our UNGC and industry-specific screens.





Source: Eastern Bank Wealth Management, powered by Arabesque

The scores shown in Charts 4 and 5 are averages, which mask individual company variations. Charts 6 and 7 show every company in our Sustainability portfolio (in dark blue) compared with the S&P 500 (in orange) and with the entire Arabesque database (in light blue). These charts place each company in relation to its UN Global Compact score on the vertical axis and its industry-specific score on the horizontal axis. Companies (dots) at the top-right corner of these charts have the highest scores on both filters, while companies at the bottom left have the lowest.

Chart 6: Eastern Bank vs. S&P 500

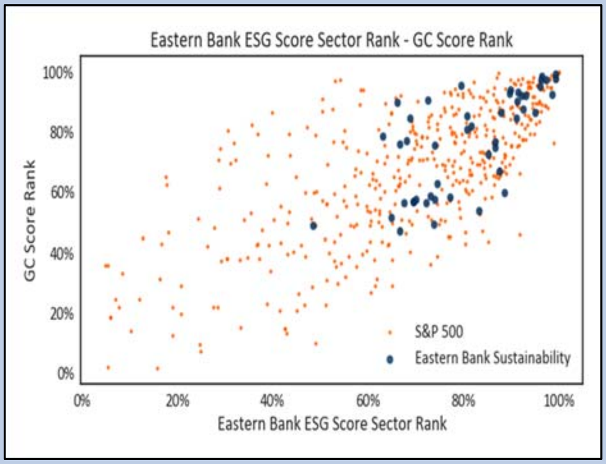
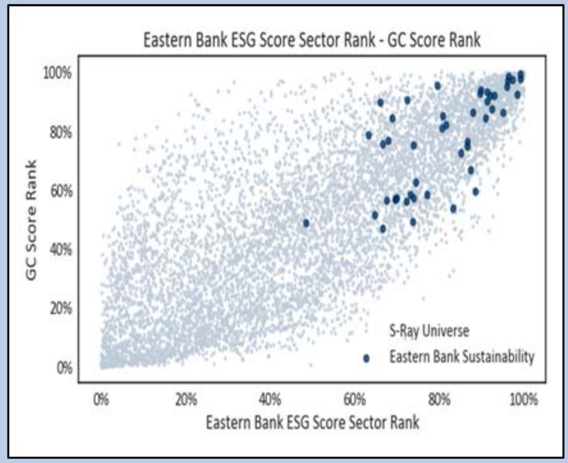


Chart 7: Eastern Bank vs. Global



Source: Eastern Bank Wealth Management, powered by Arabesque

The scatter diagrams in Charts 6 and 7 demonstrate an important feature of our divestment strategy. Plenty of orange and light blue dots lie above and to the right of the dark blue portfolio holdings; we don't look *only* at a UNGC or industry-specific ESG score in determining whether to divest a company from our portfolio. Instead, we retain our discipline in building diversified portfolios of high-quality and attractively priced companies. The ESG overlay eliminates some dark blue dots toward the lower left corners of these charts, but doesn't change the fundamental characteristics of the portfolio.

Engagement

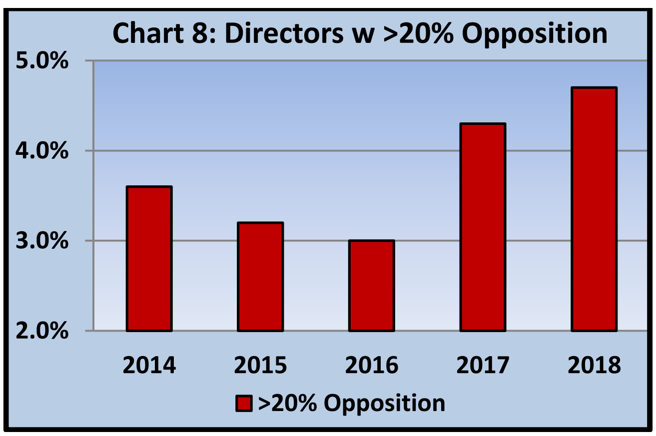
Company management teams are not composed of evil people, and corporations have immense resources at their disposal; investors can help shape dialogue and nudge CEOs toward more socially responsible ways of deploying their resources. We partner with Institutional Shareholder Services, the largest shareholder advocacy firm in the world, to identify areas where we think we can change corporate behavior for the better; operating in concert, ISS's client investment firms can exert significant influence over corporate behavior.

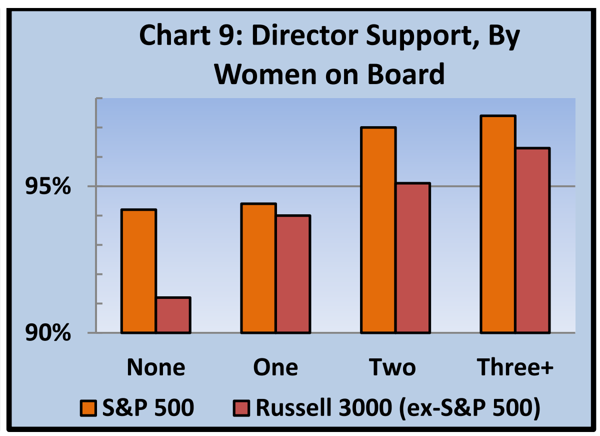
Proxy votes are hardly empty symbolic gestures; shareholders have had some notable successes in recent years. In the fossil fuel area, for example, Royal Dutch Shell and Exxon Mobil agreed to reduce their tar sands and Alaska North Slope investments following shareholder pressure; they also agreed to disclose "stranded assets" data. Likewise, PepsiCo recently committed itself to a "clean water for all" policy following shareholder activism.

In 2018, we joined with other institutional investors to advocate for change on almost 200 proxy votes, focusing our efforts on a handful of key issues:

- Opposing re-election of directors on male-only or white-only boards
- Reporting on greenhouse gas emissions and environmental sustainability targets
- Identifying and reporting on risks related to human rights violations
- Disclosing corporate lobbying activities and political donations
- Renouncing the use of prison labor
- Reporting on policies related to the use of animals in product testing
- Identifying and rectifying compensation disparities for comparable work
- Tying executive compensation to data security metrics

A deeper look at one of these topics is instructive. Investors have increasingly recognized that diverse corporate boards are highly correlated with better financial outcomes. This insight has put considerable pressure on corporations to find more female and non-white board members or to face possible ouster. Chart 8 shows that the percentage of directors facing meaningful opposition has been growing steadily, while Chart 9 shows that directors on diverse boards enjoy considerably more support than those on all-male boards.

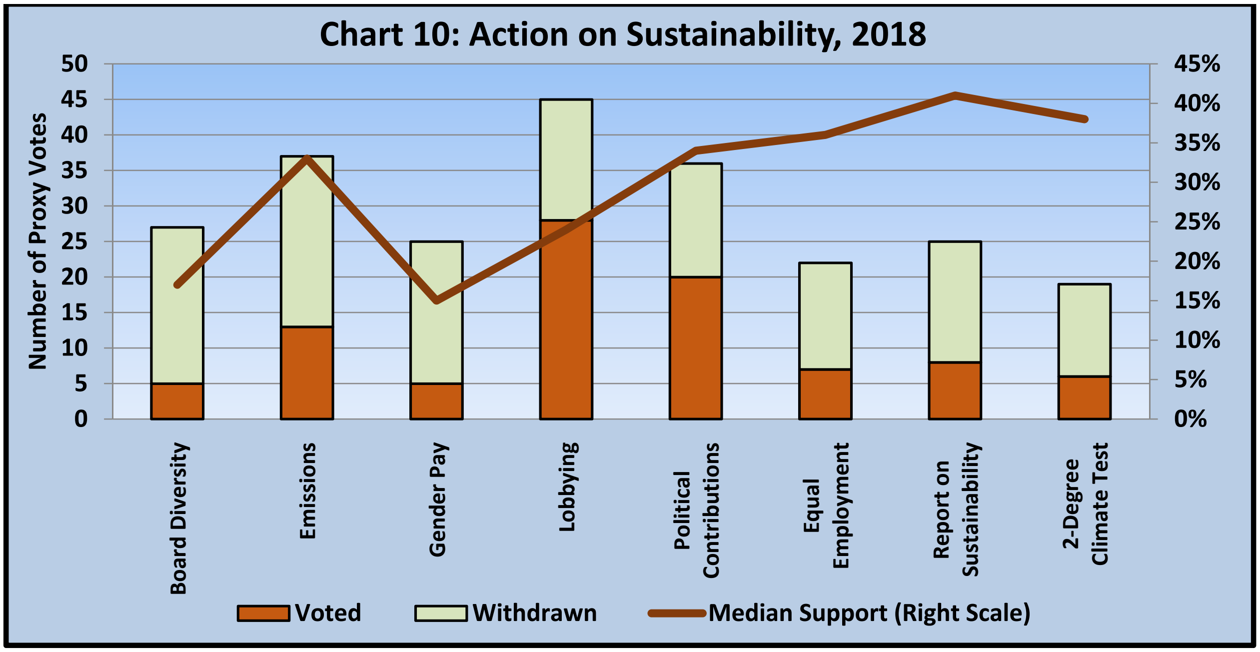




Source: Institutional Shareholder Services (both charts)

Although the directional movement in both Charts 8 and 9 shows progress, it is also clear from these charts that proxy votes by themselves are insufficient; not even 5% of directors have faced serious opposition. But to dismiss proxy voting as ineffective misses its larger point: For a values-based investor, the point of a proxy context isn't to win the vote, it's to change the corporation's behavior.

Chart 10 shows how engagement strategies really work. In 2018, a record number of shareholder resolutions were withdrawn before the actual proxy vote, as shown by the light green bars on the chart. These weren't defeats, but victories: The votes were scrubbed because management had already agreed to change its behavior. The vast majority of resolutions about board diversity, for example, were withdrawn because the corporate nominating committees put more women and non-whites on the boards without waiting for a vote.



Source: Institutional Shareholder Services

It's possible that some corporate management teams accede to shareholder engagement strategies because the executives are afraid of bad press if they don't; the solid line on Chart 10 shows that these engagement topics have received substantial support from shareholders, so a proxy battle may have amounted to a pyrrhic victory if management chose to fight rather than accept the subsequently withdrawn proposals.

But the academic literature is teeming with fresh research demonstrating a more compelling reason to adopt the kinds of behaviors that activist shareholders want: It's good for business.[4] Scholars have found that diverse boards, more disclosure of their lobbying activities, better environmental management practices, etc., are correlated with higher profitability. Although some of these policies cost money in the short term, they demonstrably add to profit margins over time. This is the real power, and the point, of engagement: It helps management make decisions that are *both* good for the planet and good for profits.

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[4] See for example "Mutual Fund Voting on Environmental and Social Proposals" by Yazhou He, Bige Kahraman & Michelle Lowry, November 26, 2018. They find that 53% of ESG proxy proposals are brought by mutual funds and other institutional shareholders, not by religious organizations or NGOs or other activists; the implication is that institutional shareholders would only raise these ESG proxies if they had good reason to expect the stock price to respond positively. (https://ssrn.com/abstract=3284683)

Similarly, Elroy Dimson, Oguzhan Karakas & Xi Li found that stock prices rose about 4.4% in the year following successful shareholder ESG engagement campaigns, controlling for all other factors. ("Active Ownership," in the Review of Financial Studies, 28:12, pp. 3225-3268, December 17, 2012. www.people.hbs.edu/kramanna/HBS_JAE_Conference/Dimson_Karakas_Li.pdf)

Finally, Rob Bauer, Tobias Ruof & Paul Smeets recently found that pension and 401(k) participants increasingly prefer sustainable investments, pushing their investment managers to buy companies with better ESG scores and thereby lifting those companies' stock prices. ("Get Real! Individuals Prefer More Sustainable Investments," working paper published November 21, 2018. https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3287430)

Positive Impact

Divestment and engagement pillars focus on established blue-chip companies, where change comes at the margin but with powerful effects stemming from the roles these large companies play in our society. Conversely, "positive impact" focuses on smaller companies that are sometimes known as disruptors or change agents. In other words, engagement seeks to change corporate behavior, while positive impact seeks to promote specific products and industries. Chart 11 shows some examples of positive impact themes:

Chart 11: Positive Impact Themes (Examples)

Environment	Resources	Social
Climate solutions	Alternative energy	Affordable housing
Energy efficiency	Food and agriculture	Inclusion & empowerment
Environmental services	Timber, metals, materials	Literacy & numeracy
Pollution control	Transportation	Personal health & well-being
Waste management	Water	Public health

Source: Adapted from Align Impact LLC

Within each of these themes lies an array of more specialized positive impact themes, and dozens of mutual funds (and a few ETFs) have sprung up to focus on various themes and sub-themes. These funds require some specialized research expertise to investigate;[5] that's why we have partnered with Align Impact LLC, a leading impact investing consulting firm, to seek out the best available fund options.[6]

Most positive impact funds share two interesting characteristics, neither of which is self-evident and both of which suggest that investors should limit their participation in these funds to a small portion of their total equity portfolio:

- First, they are very poor substitutes for a broadly diversified equity portfolio, either singly or in combination. As a group, positive impact funds tend to ignore large portions of the U.S. (or global) economy, while concentrating heavily in other areas. They also tend to focus on smaller companies, whose stock prices behave differently from the large-cap stock indexes. In some areas, portfolio companies are also heavily dependent on government subsidies to be competitive, which changes their investment characteristics.

[5] One reason to investigate carefully is that these funds are often unintentionally deceptive: For example, a "clean energy" fund might actually have substantial investments in makers of turbines for hydroelectric projects that could wipe out pristine habitat; or, to take another example, "alternative energy" funds may invest in the underlying technological enablers rather than in the actual production of alternative energy; and so on. A second reason is that there is too much money chasing too few ideas. It turns out, for example, that Maine's entire fish farm industry is smaller than some aquaculture impact funds. The names of many other putatively "positive impact" funds only passingly resemble what's actually held in the portfolios. Caveat emptor.

[6] Disclosure: Michael A. Tyler serves on Align Impact's independent investment committee, a role that helps us bring top-tier positive impact funds to Eastern Bank Wealth Management.

- Second, positive impact funds are reasonably good substitutes for private equity. The two asset classes both focus on small, fast-growing companies away from the scrutiny of most Wall Street investment firms. They both gravitate to some of the same economic sectors. Perhaps most noteworthy, they both involve fund managers building deep long-term relationships with portfolio companies, sharing knowledge and best practices. And neither asset class is highly correlated with the S&P 500 or other large-cap indexes.

In our Eastern Bank ESG Sustainability portfolios, we dedicate a portion of our equity portfolios – typically about 10% to 15% – to a carefully selected handful of positive impact funds. These funds cover a range of targeted public benefits and tend to be more broad-based than some of the narrower aims shown in Chart 11.

Conclusion

A well-crafted ESG investment strategy enables investors to avoid owning companies with poor environmental or social records, help change corporate behavior, and support smaller companies with disruptive and beneficial social impact – all without being forced to sacrifice performance. Eastern Bank's ESG Sustainability models – domestic, global, and Catholic – partner with nationally-recognized thought leaders to provide a comprehensive implementation of industry best practices in all of these areas.

> *The mountain is high, the valley is low –*
> *And you're confused on which way to go.*
> *So we've come here to give you a hand*
> *And lead you into the promised land.*[7]
> *So come on and have a free lunch!*

The Edgar Winter Group actually offered "a free ride," but we do charge a fee for our services. On the other hand, our fees are identical for traditional or ESG Sustainability portfolios, even though our ESG Sustainability portfolios entail additional resources to manage them – so our ESG Sustainability clients really do get something for nothing.

Join us for a free lunch; *join us for good.*

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[7] Surely the songwriter meant the promised land of ESG portfolios designed to match the investment characteristics of traditional portfolios, with the added bonus of sustainability.