Navigating the Alphabet Soup

A GUIDE TO ESG INVESTING

NEW YORK LIFE INVESTMENTS

Understanding ESG investing—Breaking down the terminology

If you're overwhelmed by the number of acronyms associated with ESG investing, you're not alone.

In recent years, investors have become increasingly interested in strategies that incorporate environmental, social, and governance (ESG) factors in the investing process. A 2022 report from the Forum for Sustainable and Responsible Investment (US SIF) stated that U.S. assets linked to sustainable strategies have reached $8.4 trillion, down by 13% from $17.1 trillion in 2020.[1] Many of these strategies fall under the term "ESG investing," though there's an almost dizzying number of other names, including "responsible investing," "impact investing," "socially responsible investing," "green investing," "mission-related investing," and "values-based investing," among many others. While each approach has a nuanced difference, for our purposes, we'll use the umbrella term "ESG investing" to refer to these strategies, as that appears to be the broadest and most accepted name for this category in the industry.

Along with the range of names for ESG investing, several acronyms—such as "SRI," "SDG," and "PRI"—have also emerged. For an already acronym-loving industry, the result has been an almost head-spinning number of acronyms and terms within the ESG investing universe. The result is a wake of confusion—even among proponents of ESG investing.

We're hoping to clear up the confusion for you by defining some of the key terms and acronyms of ESG investing. We'll broadly explain the differences between the major investment approaches and discuss how the United Nations (UN) Principles for Responsible Investing ("PRI") is transforming the landscape of ESG investing. We want to demystify the terminology and abbreviations, so you can understand the benefits of ESG investing without being overwhelmed by jargon and acronyms.

What does ESG stand for?

Since ESG investing is comprised of a range of issues, here is a general summary of what each term entails:

Environmental—Issues relating to the quality and functioning of the natural environment, including areas such as greenhouse gas (GHG) emissions, climate change, renewable energy, energy efficiency (i.e., air, water, or resource depletion or pollution), and waste management.

Social—Issues relating to the rights, well-being, and interests of people and communities, including areas such as human rights, labor standards, workplace health and safety, employee relations, diversity, consumer protection, and controversial weapons.

Governance—Issues relating to the governance of companies and their stakeholders, including topics such as board structure, size, diversity, skills, and independence (e.g., executive pay, shareholder rights, stakeholder interaction, disclosure of information, business ethics, bribery and corruption, internal controls, and risk management).

The original approach:
Exclusionary or Socially Responsible Investing (SRI)

The original acronym for ESG investing is "SRI"—which refers to socially responsible investing, also commonly referred to as exclusionary investing. These strategies follow an exclusionary approach—eliminating exposure to certain "sin" stocks, such as tobacco, alcohol, gambling, and weapons, or avoiding all exposure to companies in specific countries. This approach has a long history that extends back to at least the 18th century, when religious groups sought to align their investments with their worldview. For instance, the Methodists and Quakers refused to invest in entities affiliated with the slave trade. In more recent times, it's generally acknowledged that the widespread boycotts of South African companies during the 1970s and 1980s helped end apartheid.

Broadly speaking, exclusionary approaches rely on screens to filter out categories of investments that an investor wishes to avoid in their portfolio. Institutional investors have blazed the trail in exclusionary investing over the years. For example, in 2001, the California Public Employees' Retirement System (CalPERS) voted to divest from tobacco company stocks in its portfolio.[2] Public pension plans in several states, including California and New Jersey, have considered excluding companies in entire countries—such as Brunei, Cuba, Iran, Saudi Arabia, Sudan, and Turkey—due to poor human rights records and potential ties to terrorism.[3] Overall, the decision to avoid specific sectors and countries aims to do good in terms of social impact, as well as to serve as a prudent investment decision.

Exclusionary, or SRI investing generally entails avoiding sectors or countries that do not align with an investor's worldview.

The next evolution

The industry has continued to evolve—from excluding "sin" stocks—to now incorporating environmental, social, and governance factors into the portfolio's investment process. The common term used is "ESG integration" or "ESG consideration." The degree to which ESG factors are integrated into the investment process can vary. Some strategies consider ESG as one of many factors, alongside traditional financial analysis, while others use ESG strategies as a key component of the investment thesis.

One of the approaches a manager can take is commonly called "inclusionary investing" or "positive selection." This approach seeks positive ESG outcomes by selecting investments based upon their ESG characteristics. In inclusionary investing, strategies deliberately and systematically use ESG criteria to find the "best" investment opportunities to construct a portfolio rather than simply avoiding certain sectors or industries. In this way, the portfolio is "tilted" toward positive ESG characteristics or outcomes.

A broad academic report analyzing more than 2,000 studies supports the contention that companies with good ESG profiles have outperformed their traditional counterparts over time.[4] Investment managers following an inclusionary ESG approach aim to capitalize on the idea that "good" companies with positive environmental, social, and governance profiles can deliver potential alpha.

The two investment approaches just discussed—exclusionary and inclusionary—are not mutually exclusive. In fact, both can be used in a given portfolio. To summarize the nuances of these two approaches, we've provided some highlights in **Table 1** below.

Table 1: Exclusionary and Inclusionary Investing—The Two Primary Approaches

Approach	Industry Terms	Definition	Primary Purpose	Example
× Exclusionary	• Socially responsible investing • Negative selection • Negative screening	Excludes controversial companies or sectors that do not meet certain sustainability criteria	Aligning investments with an investor's values, preferences, or ethics	Eliminating tobacco or alcohol companies from a portfolio
+ Inclusionary	• Positive selection • Positive screening • Best-in-class	Investing that seeks positive ESG outcomes by selecting companies based upon their ESG profiles in their sector	Investing in sectors, issuers, or projects selected for positive ESG performance	Investing in companies with the best ESG scores/profiles in their sector

The road ahead: Impact investing

Impact investing is a growing area that goes a step further than inclusionary investing. Impact investments are made with the explicit intent to deliver measurable social and/or environmental impact as one of the objectives—in addition to delivering financial returns. In December 2021, the impact investing universe represented around $1.2 trillion of assets globally.[5]

Impact investing strategies are becoming increasingly popular with investors interested in connecting their personal values to their investments—allowing investors to provide capital to address society's most pressing issues. One helpful framework to categorize these ESG goals is the UN's Sustainable Development Goals (SDGs). These SDGs are a collection of 17 global goals set by the UN member states that address global challenges, including poverty, inequality, climate change, environmental degradation, peace, and justice. Often, impact investing strategies can align with one or more of these SDGs. An example would be a strategy that seeks to mitigate climate change by investing in clean energy solutions. This would align with SDG Goal 13 on climate action.

While impact investing represents a relatively small portion of the global investment universe, there is a lot of potential for these assets to grow.

Keep in mind that an investment strategy can use a combination of these ESG approaches, so it's good practice to understand each of these concepts. Additionally, as the industry continues to evolve in the ESG space, you may also see these terms evolve over time as well.

Industry initiatives gaining traction

The last major acronym is "PRI," also known as the "Principles for Responsible Investing." The PRI is an international organization that works to promote the incorporation of ESG factors into investment decision-making. Launched in April 2006 with support from the UN, the PRI has over 4,902 signatories covering an estimated $121.3 trillion in assets globally, as of March 2022.[6] The core philosophy behind the organization is that environmental and social considerations are relevant factors in investment decision-making and should therefore be considered by responsible investors. These institutions participate by becoming signatories to the PRI's six key principles and then filing regular reports about their progress.

While the PRI is gaining traction and taking a major role in developing responsible investment standards for asset owners and managers, there are several other frameworks that are gaining traction as well (refer to **Table 2**). Please note, this list is not exhaustive.

What’s next?

ESG investing—no matter the names or acronyms to describe it—is here to stay. We hope that deciphering some of the potentially confusing terminology, which we’ve summarized in **Table 2** below, will help jumpstart your next investment conversation in this growing area. For more information and education about ESG investing, visit us at: **newyorklifeinvestments.com** or speak with a financial professional.

Table 2: Key Investment Terms, Industry Frameworks, and Initiatives[7]

Acronym	Full Term	Definition
SRI	Socially Responsible Investing	One of the original approaches to ESG investing, an investment approach that excludes companies, sectors, or investments that do not align with an investor’s worldview or tenets.
SDGs	Sustainable Development Goals	SDGs are a collection of 17 global goals set by the UN’s General Assembly that aim to end poverty, protect the planet, and ensure all people enjoy peace and prosperity. Impact investments are made with the explicit intent to deliver measurable social and/or environmental impact as one of the objectives, in addition to delivering financial returns.
SASB	Sustainability Accounting Standards Board	A framework that aims to help businesses around the world identify, manage, and report on the sustainability topics that matter most to their investors. SASB identifies financially material issues, which are reasonably likely to impact the financial condition or operating performance of a company and therefore, are most important to investors.
TCFD	Task Force on Climate-Related Financial Disclosures	An organization that has developed voluntary, consistent, climate-related, financial risk disclosures for use by companies in providing information to investors, lenders, insurers, and other stakeholders.
UNGC	United Nations Global Compact	A principles-based framework that encourages companies worldwide to adopt sustainable and socially responsible policies and to take steps to support UN goals, such as the SDGs.

1. Source: The Forum for Sustainable and Responsible Investment (US SIF), “Trends Report 2022.”

2. Source: Randy Diamond, “CalPERS Decision to Divest from Tobacco Is Costly,” Chief Investment Officer, 12/12/18.

3. Source: Anna Petrini, “Policies Drive Public Pension Divestments,” National Conference of State Legislatures, Vol. 27, July 2019.

4. Source: Gunnar Friede, Timo Busch & Alexander Bassen, “ESG and financial performance: aggregated evidence from more than 2000 empirical studies,” Journal of Sustainable Finance & Investment, 5:4, 210-233, 2015.

5. Source: GIIN, Sizing the Impact Investing Market, 2022.

6. Source: United Nations Principles for Responsible Investing, “Annual Report 2021-22.”

7. Sources: Global Impact Investing Network (GIIN), United Nations Development Program, Sustainability Accounting Standards Board, United Nations Global Compact, United Nations Principles of Responsible Investing, Task Force on Climate-related Financial Disclosures, 2018.

ABOUT RISK

Investing involves risk, including possible loss of principal. Asset allocation and diversification may not protect against market risk, loss of principal, or volatility of returns. There is no guarantee that these investment strategies will work under all market conditions or are suitable for all investors, and each investor should evaluate their ability to invest long-term, especially during periods of downturn in the market. No representation is being made that any account, product, or strategy will or is likely to achieve profits. This material has been prepared for informational purposes only, and is not intended to provide, and should not be relied on for, accounting, legal or tax advice. You should consult your tax or legal advisor regarding such matters. This material is not intended to be relied upon as a forecast, research or investment advice, and is not a recommendation, offer or solicitation to buy or sell any securities or to adopt any investment strategy.

Impact investing and/or environmental, social, and governance (ESG) managers may take into consideration factors beyond traditional financial information to select securities, which could result in relative investment performance deviating from other strategies or broad market benchmarks, depending on whether such sectors or investments are in or out of favor in the market. Further, ESG strategies may rely on certain values-based criteria to eliminate exposures found in similar strategies or broad market benchmarks, which could also result in relative investment performance deviation. Opinions expressed are current opinions as of the date appearing in this material only and are subject to change.

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DEFINITIONS

Alpha is a term used in investing to describe a strategy’s ability to beat the market or provide excess return.

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888-474-7725

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