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THE PURPOSE-DRIVEN PORTFOLIO: EVALUATING THE SRI OPPORTUNITY

In 2010, retailing giant Target set out to give away $1 billion for education by the end of 2015. The company zeroed in on education in part because research identified it as a top concern for its customers, many of whom are mothers of young children. In catering to the considerable synergies at play between its customer base and its philanthropy, Target became part of a new wave of corporate social responsibility that has companies large and small looking for ways to be seen as sustainable while also improving the bottom line. In addition to contributing to the greater good, these policies—whether directed externally through philanthropy or internally through environmental consciousness or generous employee benefits—are also table stakes in the game to win the loyalty of the all-important Millennial employee and consumer. For investors, this trend may spell opportunity.

In recent years, socially responsive investing (SRI or sustainable investing) has enjoyed significant growth, both in assets under management and the number of products available to investors across the asset class spectrum.[1] A number of issues, from demographics to data supporting sustainability as a positive factor in investment performance, have contributed to this rise and are emblematic of a growing consciousness about the impact investors can have in the promotion of a better world.

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THE EVOLUTION OF SRI AND EMERGENCE OF ESG FACTORS

SRI in its myriad forms has long occupied a position at the intersection of mission and investing. While its earliest incarnations in the U.S. date back to religious organizations such as the Quakers and Methodists, modern-day SRI has its roots in the social movements of the 1960s, and gained steam in subsequent decades, when it was employed for mainstream purposes as well as in service of political activism, for example to help drive change in apartheid-era South Africa and war-torn Sudan.

During the last decade, the SRI mindset has evolved from a focus on the mechanics of industry avoidance (e.g., avoiding alcohol or tobacco companies) to a more formative, proactive approach that seeks to construct portfolios from the building blocks of companies with sustainable business practices. In 2007, the Rockefeller Foundation helped socialize this approach to SRI when it coined the term "impact investing" to refer to an investment program designed to produce measurable social or environmental outcomes alongside a financial return.

Alongside this shift, a set of evaluation criteria, known as Environmental, Social and Governmental (ESG) factors, has gained prominence as a means of assessing a company's sustainability alongside other key contributors to the bottom line.

Environmental factors seek to assess a company's impact on the environment, looking at a range of concerns, from its carbon footprint in light of climate change to pollution to the use of toxic chemicals, waste disposal and preservation of natural resources. An evaluation of a company's environmental impact will include an analysis of its upstream supply chain as well as its products and services.

THE PRINCIPLES FOR RESPONSIBLE INVESTMENT INITIATIVE

SRI's move into the mainstream gained coordinated global support in 2006, when the United Nations, in partnership with a group of the world's largest institutional investors, launched the Principles for Responsible Investment to promote a more sustainable global financial system. PRI signatories commit to invest their capital in accordance with six key principles. Today the PRI Initiative counts among its members nearly 1,400 firms, including Neuberger Berman, and accounts for approximately $60 trillion in assets under management.[2]

INTERPRETING THE LANGUAGE OF SRI

An explosion of SRI-related terminology has clouded the picture for many investors. What's most notable, however, is that the myriad SRI strategies available today makes it increasingly possible for investors to address their specific needs, goals—and values—within the context of their portfolios.

Sustainability: The ability to continue a particular behavior in perpetuity

Triple-bottom-line: An accounting framework developed in 1994 to measure financial, social and environmental factors within a company

Impact investing: A phrase coined in 2007 by the Rockefeller Foundation to refer to a targeted, typically private investment program designed to produce a measurable social or environmental impact alongside a financial return

Community investing: A subcategory of impact investing in which capital is invested in low income or otherwise underserved communities

Shareholder engagement: A means of influencing corporate behavior through active ownership

Economically targeted investing: An approach designed to favor investments that can yield a market rate of return alongside a collateral social benefit

Encompassing issues from a company's workplace conditions to its supply chain integrity, *social factors* have gained heightened visibility in recent years, and may include an evaluation of workers' rights, workplace safety and fair labor practices. In competitive industries, in particular, investors may be concerned about how a company can attract and incent a diverse workforce. This is particularly relevant for intellectual-capital intensive industries like financial services, research and development and technology where employees drive revenue and attractive workplace policies can give companies a competitive advantage.

In a publicly traded company, the role of corporate governance is to provide oversight to help ensure that management is focused and working on behalf of shareholders. Within the context of SRI, *governance factors* look at issues, including how boards provide oversight for sustainability initiatives

[1]US SIF Foundation, "Report on Sustainable and Responsible Investing Trends in the United States,"2014, http://www.ussif.org/trends.

[2]Source: Principles for Responsible Investment Initiative, as of April 2015.

and evaluate their impact on the bottom line, how companies incent and compensate management based on those factors, and how they disclose ESG performance metrics to investors and the public. To borrow an old cliché that "what gets measured, gets managed," governance factors offer a means of validating company performance on sustainability issues. As part of their process, fundamental portfolio managers that consider ESG factors have a unique opportunity to engage with, and potentially influence, management teams and offer insight as they evaluate sustainability issues and their impact on shareholders. Other shareholder engagement tactics include shareholder resolutions and proxy voting.

MILLENNIALS AND WOMEN LEADING THE CHARGE

Meaningful growth in SRI during the last two decades underscores investor interest in the category. Between 1995 and year-end 2013, SRI assets under management in the U.S. grew from $639 billion to more than $6.57 trillion, accounting for one out of every six dollars under professional management.[3] The same 2014 report identified 925 distinct funds that incorporate ESG criteria into the investment decision-making process, up from 55 in 1995.

While SRI has been traditionally associated with mission-based organizations, growing interest in ESG issues by the investing public at large, particularly among Millennials and women, may account for some of the gains in assets under management. Millennials may have fewer investable assets today than their more mature counterparts, but that is changing as they accumulate wealth through their own efforts and may become the beneficiaries of a portion of an estimated $30 trillion in wealth from Baby Boomers.[4] Both as consumers and investors, Millennials show a greater interest than the general public in working for, buying from and investing in companies that score well on sustainability factors. A 2015 Morgan Stanley survey of 800 individual investors with an oversample of 200 between the ages of 18 and 32, also found that Millennials are almost twice as likely to invest in companies or funds that target social or environmental outcomes, and are more than twice as likely to exit an investment due to objectionable corporate behavior.[5]

Women, meanwhile, are also demonstrating a strong interest in SRI strategies. In the 2013 edition of its annual *Insights on Wealth and Worth Survey* of 711 adults nationwide with investable assets of at least $3 million, U.S. Trust found that 65% of women feel it is important to consider the positive or negative social, political and/or environmental impact of the companies in which they invest, compared with 42% of men. In the same survey, 56% of women reported that they would be willing to trade some performance for investing in companies with a greater positive social impact, compared with 44% of men.[6] With women often joint voices or sole decision-makers in the management of household finances, their interest in ESG issues is likely to continue to be a factor in the growth of SRI strategies.

PERFORMANCE POINTS THE WAY FORWARD

While sustainability factors do not measure financial performance, there is a growing body of evidence that these less-tangible issues can positively impact a company's profitability (see below). It follows that a company with engaged employees or one that manages resources efficiently may offer competitive advantages, with the potential to achieve better long-term financial performance, than a similar company that measures poorly on such sustainability issues.

The evidence supports this theory. Over a 15-year period, in aggregate, actively managed SRI equity funds in the U.S. outperformed their peer group and the S&P 500 on an absolute and risk-adjusted basis (see chart).[7] Research conducted by MSCI on two higher tracking error global strategies constructed using ESG data over an eight-year period also concluded that it was possible to improve returns on both an absolute and risk-adjusted basis by incorporating ESG factors into the investment process.[8] Further, a 2012 study by a trio of Harvard Business School professors using a matched sample of 180 U.S. companies found that high-sustainability companies—those that adopt rigorous sustainability policies such as giving the board of directors responsibility for sustainability, tying executive compensation to ESG metrics and auditing and disclosing this non-financial data—outperformed low-sustainability companies on

[3]US SIF Foundation, "Report on Sustainable and Responsible Investing Trends in the United States,"2014, http://www.ussif.org/trends.

[4]Accenture, "The 'Greater' wealth transfer: Capitalizing on the intergenerational shift in wealth," 2012, https://www.accenture.com/us-en/insight-capitalizing-intergenerational-shift-wealth-capital-markets-summary.aspx.

[5]Morgan Stanley Institute for Sustainable Investing, "Sustainable Signals: The Individual Investor Perspective," February 2015.

[6]US Trust, "Insights on Wealth and Worth," 2013.

[7]Source: Morningstar, Neuberger Berman, Forum for Sustainable and Responsible Investment.

[8]MSCI Research, "Can ESG Add Alpha", June 2015, https://www.msci.com/www/blog-posts/can-esg-add-alpha-/0182820893.

SUSTAINABILITY: A POSITIVE FACTOR IN LONG-TERM RETURNS[1]

Growth of $10K of All U.S. Actively Managed Socially Responsible Equity Funds versus S&P 500 Index and Peer Average

Source: Morningstar, Neuberger Berman, Forum for Sustainable and Responsible Investment. **Past performance is no guarantee of future results.** Please see disclosures at the end of this publication. Data Time Period: 7/1/2001 – 12/31/2015.

measures of stock market and accounting performance.[9] A 2011 article in the *Journal of Financial Economics* found that companies with higher levels of employee satisfaction outperformed the market by 2% to 3% annually.[10]

ESG factors cover myriad issues—e.g., pollution, waste disposal, human rights, pay equity, quality of materials—that can impact a company's reputation and may affect the likelihood that it will face litigation. As a result, ESG factors are becoming a more integral component of the conversation about a company's quality. In determining its annual list of top-performing CEOs, *Harvard Business Review* validated this viewpoint in 2015 when it began evaluating ESG criteria alongside company performance metrics. Its methodology now weights ESG factors at 25% of a CEO's total performance score.[11]

MEASURING THE SUSTAINABILITY CONTRIBUTION

The growth of SRI appears on track to continue, particularly as Millennials gather and invest their assets, and institutional defined contribution and defined benefit plans further emphasize ESG factors following a favorable Department of Labor ruling in 2015 stating that ESG integration does not violate fiduciary duty.[12] As the category continues to evolve, the number of strategies available across asset classes—both actively and passively managed—is also likely to increase. While methods for companies to report on their sustainability efforts exist, however, they can be challenging to verify. We believe passion should not be passive, and that SRI is likely to be a category where active managers can distinguish themselves by employing fundamental research as they seek to identify companies that are differentiated on ESG and other factors that may be critical to performance.

[9] Robet Eccles, Ionannis Ioannou, George Sefaphim, Harvard Business School, "The Impact of Corporate Sustainability on Organizational Processes and Performance," 2012, http://www.hbs.edu/faculty/Publication%20Files/SSRN-id1964011_6791edac-7daa-4603-a220-4a0c6c7a3f7a.pdf.

[10] Alex Edmans, *The Journal of Financial Economics,* "Does the stock market fully value intangibles? Employee satisfaction and equity prices," 2011, vol. 101, issue 3, pages 621-640.

[11] Harvard Business Review, "The Best-Performing CEOs in the World," November 2015, https://hbr.org/2015/11/the-best-performing-ceos-in-the-world.

[12] U.S. Department of Labor, "Economically Targeted Investments (ETIs) and Investment Strategies that Consider Environmental, Social and Governance (ESG) Factors," October 22, 2015, http://www.dol.gov/ebsa/newsroom/fsetis.html.

Q&A WITH INGRID S. DYOTT, PORTFOLIO MANAGER, SRI CORE EQUITY TEAM

1. What explains the rapid growth in SRI assets?

From a wider industry perspective, the 2014 SIF Trends survey indicates that managers who incorporate ESG factors into their investment process cited client demand for fulfilling values and mission as the greatest motivator, followed by the desire to generate social benefits, minimize risks and seek financial returns.

From my perspective, there are three drivers. First, more mission-related investors have seen SRI strategies succeed and are investing in the space with history on their side. Second, with wider acceptance of ESG factors as material to performance, the category is attracting a broader investor base. Last but not least, long-term investors like foundations, endowments and pension funds are seeking ways to ensure the long-term financial health of their portfolios and increasingly are interested in sustainability issues.

2. How do you explain the appeal of SRI among women and Millennials?

Millennials witnessed the corporate scandals of the early 2000s and the 2008 financial crisis as young adults. As a result, they place a high value on ethics and responsibility. Meanwhile women, especially those in caregiving roles, are placing a higher priority on values and key sustainability criteria, recognizing that these characteristics can be drivers of good businesses over the long-term.

3. What kinds of questions do you get from investors and how have they evolved in recent years?

We have seen SRI move from being defined by "what not to own" to being defined by "know what you own." While the NB SRI Core Equity team has always incorporated "leadership" criteria, we are enthused to see more investors interested in sustainability strategies as awareness has grown that ESG factors can be relevant to a company's business. Questions we get typically reflect ongoing environmental, employee and governance practices. They are also influenced by societal events like violence in schools, environmental disasters and human rights issues, typically in the supply chain.

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SRI Equal Weighted Average: Consists of all U.S. actively managed socially responsible equity funds, as identified by Morningstar and the Forum for Sustainable and Responsible Investment, with a track record dating back to 2001.

Morningstar Large Blend Average: Morningstar Average is the average of all the funds in the Morningstar category. The Morningstar category identifies funds based on their actual investment style as measured by their underlying portfolio holdings (portfolio statistics and compositions over the last 3 years). This category was chosen for comparison purposes because the portfolio compositions of the funds in this category are similar to the composition of the fund over this period.

S&P 500: Consists of 500 stocks chosen for market size, liquidity, and industry group representation. It is a market value weighted index (stock price times number of shares outstanding), with each stock's weight in the Index proportionate to its market value. The "500" is one of the most widely used benchmarks of U.S. equity performance. As of September 16, 2005, S&P switched to a float-adjusted format, which weights only those shares that are available to investors, not all of a company's outstanding shares. The value of the index now reflects the value available in the public markets.

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