How to combine investment objectives and ESG preferences

An environmental, social, and governance approach helps investors pursue what matters most to them.

It’s inevitable: At a sporting event, in the airport, or while out running errands, thirst strikes. Grabbing a cold bottle of water from a vending machine or convenience store is cheap and easy. But, would it be wiser to spend more cash up front on a reusable bottle that can be refilled repeatedly?

Behind that question are dozens more, including: Which option is better for the environment in the short term? How about the long term? If there is an easy way to recycle the single-use bottle, does that change the equation? How convenient are water fountains and other places to refill the reusable bottle? And what about the several reusable bottles left sitting on the kitchen counter at home—do they change the equation?

In this scenario, an individual’s concerns boil down to three main considerations:

1. How quickly they’ll achieve the goal of quenching their thirst
2. The risk that choosing the wrong container could have immediate negative consequences personally
3. How this decision will play out—both individually and for the world—in the long term

Of course, an individual decision about a drinking container appears to have a negligible impact on the world. But if every person chooses the single-use bottle every single time, that compounded impact is significant. Institutional investors have the critical mass to take that dynamic one step further—they can make choices that affect investment returns and risk and the world around them.
Pursuing both investment performance and a positive impact on the world used to exceed most investors’ abilities. But today more companies and other issuers of financial securities are disclosing the information investors need to measure sustainability and impact. At the same time, advancements in technology—specifically in data analysis—have made it easier for investors to parse this information and assess its impact on their investments and the impact of their investments on the world.

The timing of this change is important. Decisions about where and how to allocate effort and resources help shape the future. And perhaps now more than ever, we see the world changing substantially due to factors such as climate change, natural resource availability, and demographic shifts. Investors aware of these environmental, social, and governance (ESG) issues are helping prepare their portfolios for the economy of the future.

With such a lens, investors can evaluate investments on a much broader range of criteria than they could in the past. As a result, they have the freedom to decide which factors are most important to them, articulate financial and ESG objectives, and understand where those objectives intersect.

Putting ESG into action

The world of ESG investing is broad, complex, and saturated with data, but that data can be overwhelming. There are myriad standards for analyzing that information and countless strategies for acting on it. Fortunately many initiatives are underway to create clarity as demand increases. Integrating ESG systematically in four phases can help investors manage the complexity of ESG while working toward their goals.

No two ESG investors are cut from the same cloth. Fortunately, the breadth of the ESG universe lets investors express their unique points of view in their portfolios. Investors can explore ESG and educate themselves using the following steps:

1. Determine ESG values and priorities
2. Assess the existing portfolio
3. Align investment strategies with ESG objectives
4. Monitor ESG investing outcomes

54% of investors either have a responsible investing policy in place or are in the process of developing one.

Determine ESG values and priorities

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- **Set a goal.**
  Investors should articulate why they’re pursuing ESG and what they hope to achieve. For example, an investor may want to take a limited approach at first, fully align their organization’s investments with its mission, or proactively allocate capital to shape the future they want to see.

- **Build knowledge.**
  Gather information and evidence that can help answer relevant questions. Seek the views of stakeholders—employees, trustees, partners, and any others whose points of view are relevant. Investors can reach out to experts in their industry and in ESG.

- **Examine the context.**
  Investors may be able to take direction from their organization’s value and belief statements, such as its overall mission or sustainability commitments. The demographics and priorities of critical stakeholders may also be factors worth considering.

- **Evaluate the portfolio objective and structure.**
  Consider it at a high level: What is its ultimate investment objective? Is the portfolio invested in assets to fund retirement benefits? Is it focused on managing working capital? Investors should also assess how much control they have over the portfolio’s composition—how the assets are managed and structured and thus what types of changes they are able to make.

- **Articulate ESG investment beliefs.**
  In the final step of this phase, investors can use the information and perspectives they’ve gathered to state their unique vision for ESG investing. For example, an investor might decide to use ESG to enhance returns, assess and manage risk, express specific values, and/or finance particular impacts on the world.
Understanding ESG

ESG-related issues may create risks to a company’s reputation, operations, or finances. For example, scandals or labor disputes can prompt boycotts and tarnish a company’s brand, or climate-related weather phenomena may disrupt supply chains. Each scenario can affect profits or asset values.

ESG also may present commercial opportunities. For instance, corporate sustainability may bolster talent attraction and customer relationships, while clean-energy products may benefit in the transition to a low-carbon economy.

Some examples of ESG concerns and opportunities:

**Environmental:**
Renewable energy, waste management, water use, climate change

**Social:**
Human capital, community relations, labor standards, diversity and inclusion

**Governance:**
Accounting, board structure, executive compensation, business ethics, and fraud

Assess the existing portfolio

With initial discovery complete, it’s time to dive into the portfolio’s details for a diagnostic. Investors should examine how well the portfolio currently aligns with their beliefs and objectives. Consider the following steps:

- **Analyze current holdings.**
  Determine the ESG characteristics of current holdings. External managers or custodians can help collect and interpret the data. Scoring tools supplied by ESG research vendors or portfolio management platforms may also provide useful perspectives.

- **Survey existing managers.**
  Through due diligence questionnaires or regular portfolio reviews, ask current portfolio managers to detail their ESG philosophy, policies, processes, and performance.

- **Compare the current portfolio with the ESG vision.**
  Investors must assess whether the current portfolio, including the manager roster, aligns with their beliefs and objectives. Look for potential conflicts—for example, positions in stocks of companies that make products harmful to health might not be consistent for a health care entity.

- **Engage internal stakeholders.**
  Share the results of this analysis and request input from staff, board members, and other key stakeholders. It may help to select a handful of metrics that illustrate ESG exposures and performance and use them to help stakeholders understand ESG dynamics.
Align investment strategies with ESG objectives

This phase is where the rubber meets the road, as investors shift managers, allocations, and/or investments to integrate ESG.

- **Formalize the approach.**
  Document ESG beliefs and objectives in the Investment Policy Statement. Alternatively, create a specific ESG Investing Policy Statement and/or a document that outlines expectations of portfolio managers.

- **Define the scope of the effort.**
  Decide whether the strategy encompasses a specific asset class or the total fund and adjust the policy benchmark, the model portfolio, and other elements accordingly.

- **Develop an implementation plan.**
  Identify tasks, responsible parties, and timelines for implementation. Also determine how success will be measured.

- **Communicate the changes.**
  Give new and existing managers the information they need to implement the ESG approach, including the rationale. Aim to eliminate ambiguity: Clearly describe which actions are required and which are simply desirable.

- **Implement portfolio changes to meet ESG objectives.**
  The path to implementation will depend on an investor’s specific objectives, portfolio, and other considerations. They may include withdrawing capital from exposures that are misaligned with objectives; shifting capital to exposures that are aligned with objectives, such as lower carbon investments or diverse managers; integrating ESG metrics into research, security selection, and/or the portfolio construction process; aligning proxy voting with ESG beliefs and objectives; or engaging with securities issuers to express a point of view.

The value of industry engagement

ESG is a vast, rapidly evolving arena. Engaging with peers and industry experts can help investors stay current. Investors might consider:

- **Collaborations and partnerships with peer organizations.** For example, pension funds might seek out fellow asset owners, while foundations could network with like-minded peers.

- **Membership in industry groups.** Global sustainable investment organizations such as the U.N.-supported Principles for Responsible Investment or the Global Impact Investing Network provide education, resources, and networking opportunities. Other organizations tailored to specific locations or topics may provide a compelling value proposition.

- **Academic or nonprofit partnerships.** These can help provide valuable expertise and expand an investor’s ability to understand and implement ESG practices.
Monitor ESG investing outcomes

Assessing a portfolio’s risk and return is a task that’s never finished—and ESG implementation is never complete. For ESG efforts to succeed, investors must monitor their portfolios’ alignment with their ESG objectives over time. Likewise, it’s essential to continue giving stakeholders the information they need on an ongoing basis.

- **Establish systems for ongoing measurement and monitoring.**
  Track metrics such as changes in portfolio exposures from the baseline and compliance with the specific investment rules that have been established.

- **Monitor the market and the ESG environment.**
  ESG best practices are continually evolving. Investors should keep up with the changes, as well as the market context they’re operating within, so they can continue working toward their objectives efficiently.

- **Evaluate managers regularly.**
  Check that managers are collecting the specific metrics and data you’ve requested and are working to meet stated ESG objectives. Investors can use due diligence questionnaires or regular portfolio reviews to gather this information.

- **Fine-tune the ESG strategy.**
  ESG objectives may change over time due to shifts in priorities and/or trends in the market. Maintain an ongoing dialogue with stakeholders and adjust the investment strategy as necessary to meet those objectives.

Incorporating the ESG dimension can help investors more accurately define what investment success means to their organization and then construct a portfolio that reflects that vision. The preceding list may seem daunting. But as the saying goes, the journey begins with a single step. Investors can marshal their resources, establish a goal, and begin to move ahead as they integrate return, risk, and ESG factors into their vision of success.

Investing for the future

Our investing teams and the Wells Fargo Asset Management (WFAM) ESG team believe that investors have the power to shape their portfolios for the environment they operate within today while also positioning them wisely for the future. For more than 30 years, we have employed ESG-related insights in our investment solutions and approaches and are now working with entities across the globe on some of the most exciting areas of sustainable investing developments. We’re committed to helping investors understand, analyze, and implement ESG strategies to pursue their own goals and those for the world at large.

Please contact us if you’d like to discuss:

- Adopting an ESG investment lens
- Assessing the ESG characteristics of an existing portfolio
- Aligning investment strategies with ESG objectives
- Monitoring and updating ESG investing outcomes

The ESG data universe is best described as semi-organized chaos. The quantity of data has exploded, but the quality of that data, as well as how useful it is for making decisions, is still limited.

Christopher McKnett,
WFAM Senior ESG Investment Strategist

Reflecting a focus on the importance of ESG concerns in investment strategies, this segment highlights the need for ongoing monitoring and evaluation. The text suggests a structured approach to managing ESG-related risks and opportunities, emphasizing the continuous evolution of ESG best practices and the importance of regular assessment of managers and strategies.
Case study

From pilot project to firm-wide framework
How one company put an ESG plan into action

What does it look like when an investment organization prioritizes a global systemic issue while also maintaining its focus on performance?

One of our clients—an international wealth management platform—recently did just that, piloting an effort to accommodate climate change dynamics into its overall portfolio strategy.

The wealth manager—on behalf of its clients—wanted to use ESG analysis to understand and mitigate the risk of climate change on the performance of certain securities in its portfolio. At the same time, the wealth manager wanted to make this type of climate-related analysis more robust and also more common in the industry.

Many investors want their portfolios to achieve multiple objectives. They need ways to express and quantify how well they’re performing on each objective. We’re ready to tackle that challenge.

The first step is usually education. In the case of the wealth management platform, the investment team that managed the client’s assets partnered with our ESG strategist team on a deep-dive into the investment implications of climate change. The study covered policy and technology shifts, scenario analysis, and the tools and data that could be used to assess investment outcomes. Although the team was already mindful of climate change, the needs of our client helped sharpen our approach.

With education, investors are better equipped to articulate their ESG values, determine how their current portfolio measures up, and plan what to do next. For instance, for the wealth management client, we developed a framework to integrate climate risks into our security analysis and to understand the ways those risks are present in the portfolio, including a process to quantify the equity value at risk from climate change. The client was able to inform its climate risk positioning. Even better: Our investment team is now using this framework to assess climate risk across all of the assets it manages.
We want to help clients build for successful outcomes, defend portfolios against uncertainty, and create long-term financial well-being. To learn more, investment professionals can contact us:

- To reach our U.S.-based investment professionals, contact your existing client relations director, or contact us at WFAMInstitutional@wellsfargo.com.
- To reach our U.S.-based intermediary sales professionals, contact your dedicated regional director, or call us at 1-888-877-9275.
- To discuss environmental, social, and governance (ESG) investing solutions, contact Hannah Skeates, global head of ESG at Wells Fargo Asset Management, at hannah.skeates@wellsfargo.com.

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