

Litman Gregory

ASSET MANAGEMENT

Sustainable Investing



Whether it's initiatives focused on protecting the environment or how companies treat their employees, the concept of sustainability has become mainstream. People want to better understand how their actions impact the environment and the world around them, and more importantly, they want to do their part to make things better.

Sustainability is also transforming the investment industry. Increasingly, investors are seeking investment solutions that reflect their personal values and take into account sustainable objectives while also delivering long-term financial success. More than just a way to do good or a statement of principles, sustainable investing is quickly becoming recognized as a way to create lasting positive and tangible environmental and social impact, while still meeting investment return objectives.

Sustainable investing strategies have grown globally. Studies indicate more than \$20 trillion is dedicated to sustainable investing strategies around the world and over 25% of all professionally managed assets in the United States are invested according to these principles¹.

In many ways, we view sustainable investing as an evolution of traditional investment portfolios that will unfold over the years ahead as financial and non-financial considerations impact investment decisions and lead to better outcomes overall.

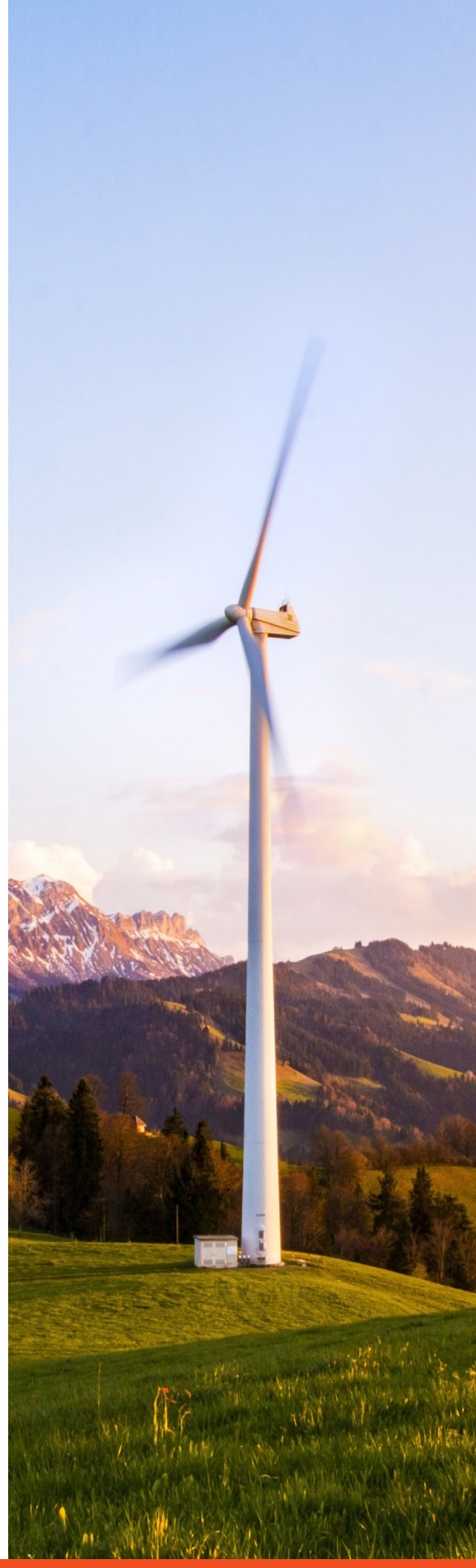
Sustainable Investing Approaches

There are many ways in which an investor can implement a sustainable investment approach. Historically, sustainable investing strategies have generally fallen into one of two categories: those that seek to avoid exposure and those that target a specific outcome.

For many investors, the most well-known sustainable investing approach is Socially Responsible Investing (SRI). SRI strategies, also commonly known as "values-based" or "do-no-harm strategies," are designed to reflect an investor's religious, personal, or ethical beliefs. For example, many SRI strategies will exclude alcohol, tobacco, certain weapons-related companies, or other companies, sectors, or industries that can be considered controversial or offensive. Energy stocks are another common type of exclusion. While SRI strategies can be an effective way to reflect one's personal beliefs, research has shown that reducing your investment opportunity set by excluding certain sectors has had a negative impact on investment performance over time.

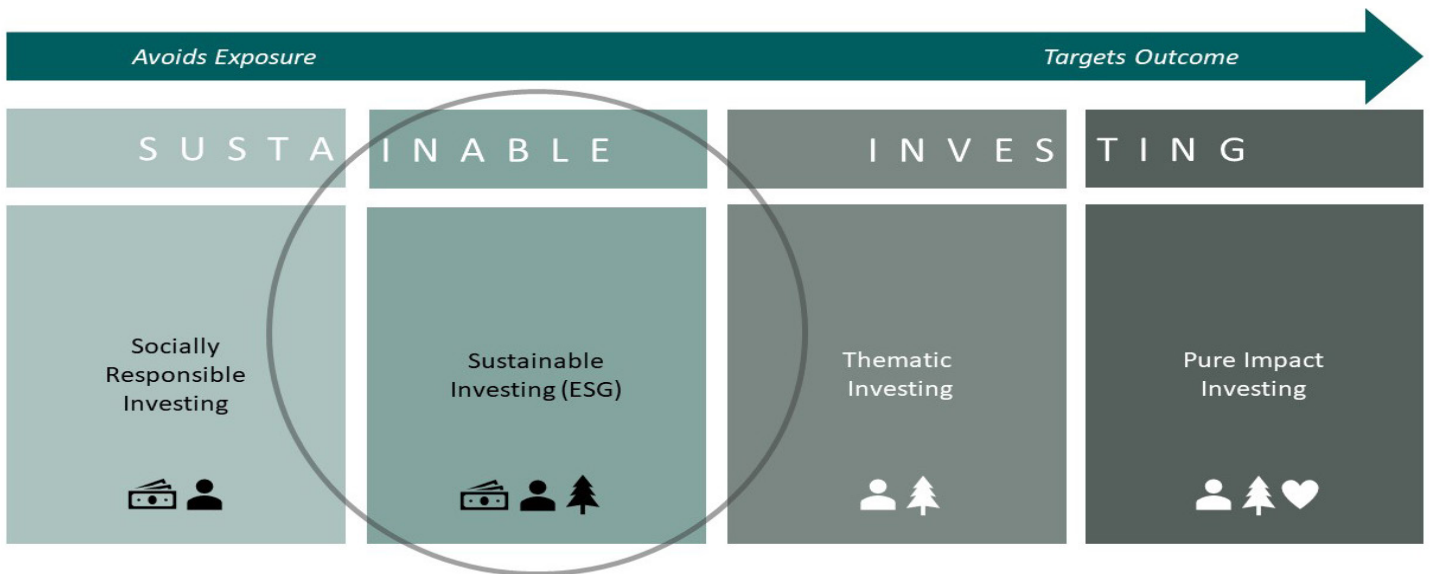
On the other end of the spectrum lies Impact Investing. Impact strategies invest with the intention of generating a positive, measurable impact, alongside an acceptable investment return, by investing in public companies but also potentially non-profits or other non-traditional investment vehicles, often in a private vehicle (as opposed to a

¹ USIFF Forum for Sustainable and Responsible Investing, 2018 Trend Report



traditional mutual fund). These strategies could be considered the purest form of sustainable investing, as investment dollars are directed toward the specific outcomes that matter most to the investor. But they may not be accessible to all investors; moreover, the bar for vehicles that truly achieve a measurable outcome is very high.

Within a more traditional portfolio framework, another important approach is Thematic Investing, which concentrates investments on a specific idea or theme, like clean energy, gender diversity, or climate change. These can be appealing approaches to complement a diversified portfolio for investors who have strong convictions. However, from a performance perspective, concentrating your investments in a singular theme is likely to result in volatile performance and without proper overall diversification it will make it difficult to reach long-term return objectives.



The framework that most closely integrates sustainability with traditional investing is ESG investing, by which issues related to environmental, social, and governance sustainability are integrated into the portfolio management process. Because of its close connection to investment strategies most investors understand and already pursue, we (and many others) view ESG as an effective approach to sustainable investing. ESG investing strategies may combine elements of SRI and Impact alongside a core focus on investing with high-quality companies for which there is a strong financial and non-financial investment case, often working with those companies to drive positive change and long-term shareholder value. Importantly, we believe ESG strategies offer better flexibility than more restrictive approaches, can be executed to help clients reflect their personal values, and encourage positive environmental and social practices, while also allowing clients to realize their long-term investment goals.

How ESG Strategies Align with Social Outcomes

ESG strategies invest in companies that are perceived as leaders, or that are showing marked improvement, in promoting best practices on a variety of environmental, social, and corporate governance issues. The idea being that companies who possess strong or improving ESG characteristics will ultimately lead to positive social and financial outcomes. (As a related point, companies that are strong or improving their ESG characteristics may be amenable to additional positive changes driven by their shareholder base through proxy voting or shareholder resolutions.)

Companies are adopting more sustainable business practices, and from an investment perspective, sustainability data is becoming more robust. Over the past two decades, the level of climate-related, environmental, and sustainable reporting data has increased significantly to the point where it's becoming prevalent across the investment industry. Much in the same way that an investor can assess the revenue and profitability of a company, analysts can now assess the environmental and societal impact of a company relative to its peers. (That said, ESG data has quite a bit further to go in achieving the consistent quality and depth of today's available financial data. But the area of data integrity is getting a lot of focus from SRI or ESG organizations and from large investment firms and institutional investors.)

ENVIRONMENTAL

SOCIAL

GOVERNANCE



- Carbon emissions
- Air and water pollution
- Energy efficiency



- Customer satisfaction
- Labor standards
- Data protection and privacy



- Executive compensation
- Board independence
- Shareholder rights

As a starting point, most ESG strategies will apply an avoidance screen to exclude certain products or industries from their portfolio (like alcohol, tobacco, and firearms). From there, fund managers can apply an ESG analysis by which companies get evaluated versus their peers on a variety of environmental, social, and corporate governance factors.

In practice, ESG analysis can be applied to investment decisions in a variety of ways. Some fund managers choose to invest in only “best-in-class” companies, those that have strong ESG performance relative to peers. Others apply a more absolute strategy in which they avoid companies that don’t meet a minimum level of ESG quality, even if the firm is significantly better than their industry peers. (The definition of “quality” is not standardized.) While others take it a step further and implement sustainability “themes,” such as renewable energy, water management, low carbon, and gender diversity.

Promoting positive social and environmental change through corporate engagement is another key outcome for ESG strategies. However, engagement is tricky. Individual investors are usually unable to make their voices heard. Professional fund managers, on the other hand, have the ability to influence corporate behavior toward more sustainable business practices through a variety of measures, including engaging with company management on sustainability issues, proxy votes, and shareholder proposals, among others.

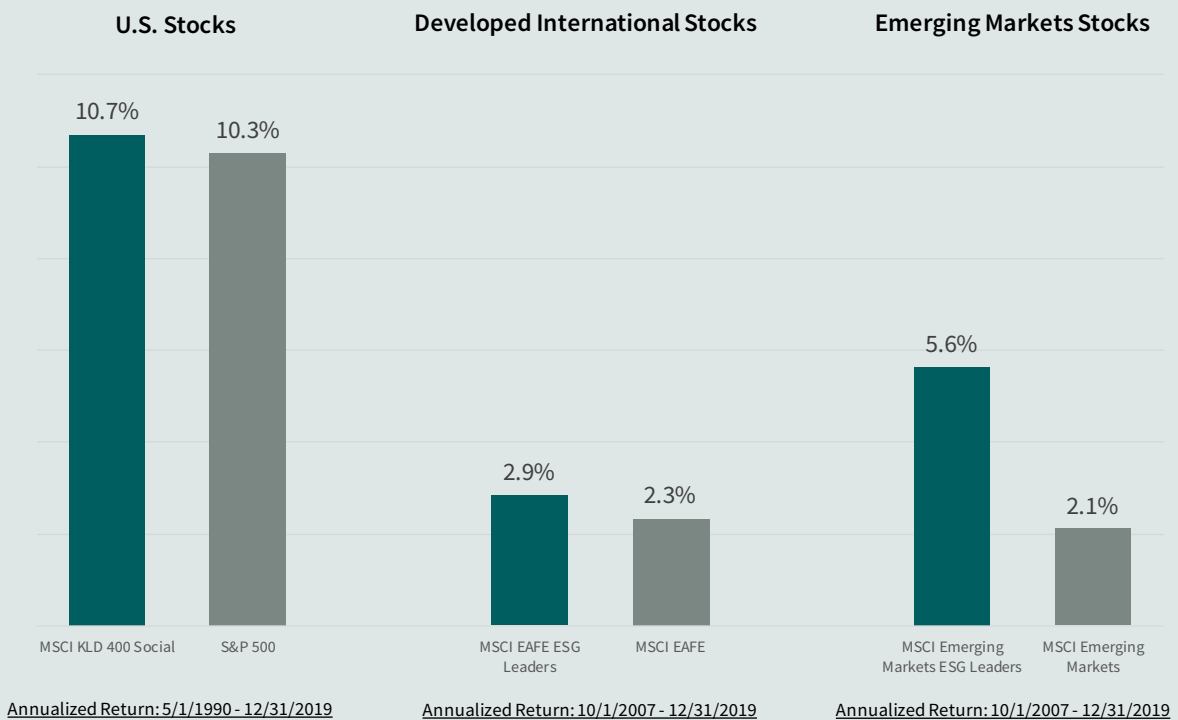
The underlying goal of ESG strategies is to favor those businesses with a more sustainable footprint and to avoid any company with egregious patterns of behavior around workplace, environmental, or other social issues, while still achieving a competitive rate of investment return. Increased scrutiny of corporate practices sponsored by large pools of shareholder dollars combined with more general public awareness and pressure can have—and is having—the effect of changing corporate behavior toward more sustainable practices.



Sustainable Investing and Performance

As with any investment approach, one of the measures of sustainable investing strategies will be how they perform. Beyond achieving the peace of mind that your investments are having a positive impact, numerous studies have shown that companies who operate in a sustainable manner can provide better investment performance². Intuitively, this makes sense. If high-quality fundamental analysis can identify well-run companies, incorporating ESG analysis, focusing on reputational, regulatory and environmental risk, should be able to capture unforeseen non-financial risks that can negatively affect performance. ESG analysis attempts to minimize these negative surprises, which we believe has the potential to improve long-term, risk adjusted returns.

The chart below shows the performance for US, developed international, and emerging market stocks versus their ESG equivalents. This is a simple example, but as we can see, incorporating an ESG overlay has resulted slight outperformance relative to their broad market counterparts.



In Conclusion

Sustainable investing has been around for decades. However, only more recently, as sustainability has become more mainstream and investor interest has grown, have we started to see a greater number of high-quality investment options become available. As the ESG landscape continues to grow, bringing more and higher-quality investment options, we can enhance the value we're able to deliver to clients in both investment results and sustainable outcomes.

The Litman Gregory ESG portfolios offer investors access to a range of globally diversified, risk-managed portfolios, that help clients realize their long-term investment objectives, while also focusing on global sustainability.

Please consult your Advisor to learn more about the ways you can invest in ESG and how these strategies could impact your overall investment plan.

²"The Impact of Corporate Sustainability on Organizational Processes and Performance", Robert G. Eccles, Ioannis Ioannou, and George Serafeim

About Litman Gregory

Founded in 1987, Litman Gregory is a nationally recognized boutique wealth management firm based in the San Francisco Bay Area. Since its founding, Litman Gregory has provided investment advisory and wealth management services to individuals, multi-generational families, and institutions. Over the years, we've also had the opportunity to share the research, investment portfolios, and communications we're providing our own clients with other financial professionals to use with their clients. Financial advisors have been selecting Litman Gregory as a research partner and investment strategist for their clients since 1996.

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