



Revised and Extended Remarks at the Greenwich Roundtable Panel Discussion on ESG: Path to Prosperity or Philanthropic Confusion

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Greenwich, CT
January 17, 2019

Good morning, and thank you for inviting me to the Greenwich Roundtable. I plan to cover several aspects of Environmental, Social, and Governance (ESG) investing, starting with some historical context then touching on the regulatory landscape. Mostly, we will talk about the ‘value’ vs. ‘values’ distinction and the data behind value-driven investing. And finally, I will touch on investment stewardship and the role of asset owners.

Historical Context

ESG & Sustainable Investing reflects a decades-long journey. As I will discuss today, what began as a ‘values’ discussion has evolved over time and is increasingly about ‘value’, and the idea that governance, environmental and social issues can drive investment value over time.

In April, 2006, the Principles of Responsible Investing (PRI) were launched with 63 signatories accounting for \$6.5 trillion of assets under management.¹ The PRI’s goal was “to commit to... incorporate ESG into investment analysis and decision making processes” and to “report on...activities and progress towards implementing the Principles.”² Over the past 12 years, the PRI have grown to over 1900 signatories accounting for over \$80 trillion in AUM.³ In the past five years alone, the number of signatories has increased by 65% and AUM has increased by 240%.

ESG factors are gaining prominence in the asset management industry and are now incorporated into a sizable portion of the world’s managed asset. According to the Global Sustainable Investment Alliance (GSIA), approximately 26% of the assets under management globally already incorporate ESG factors in some form.⁴ Not surprisingly, companies and asset owners are aligning their businesses and their investments with the UN Sustainable Development Goals (SDGs).⁵ According to KPMG’s survey of Corporate Responsibility Reporting, 40% of the world’s 250 largest corporations discuss the SDGs in their corporate reporting.⁶

While we can all agree that interest in sustainable investing has soared within the business community, there is little agreement about what is actually being discussed. The problem starts with a range of definitions of terms. For example: ‘ESG Investing’, ‘Sustainable Investing’,

¹ “About the PRI”, PRI, available at <https://www.unpri.org/pri/about-the-pri>.

² “What are the Principles for Responsible Investment?”, PRI, available at <https://www.unpri.org/pri/what-are-the-principles-for-responsible-investment>.

³ See Footnote 1.

⁴ “2016 Global Sustainable Investment Review”, Global Sustainable Investment Alliance, pg. 7, available at http://www.gsi-alliance.org/wp-content/uploads/2017/03/GSIR_Review2016.F.pdf.

⁵ More information about the UN Sustainable Development Goals available at <https://www.un.org/sustainabledevelopment/sustainable-development-goals/>.

⁶ “How to report on the SDGs: What good looks like and why it matters” (Feb. 2018), KPMG, pg. 6, available at <https://assets.kpmg/content/dam/kpmg/xx/pdf/2018/02/how-to-report-on-sdgs.pdf>.

'Responsible Investing', 'Ethical Investing', and 'Impact Investing' are often used interchangeably, requiring one to consider the speaker and the context of their remarks to understand the meaning of the terms.

Current Debate

The increased interest in sustainable investing has led to a public debate about whether corporations should pursue 'Profit or Purpose', a debate which is sometimes framed as 'Milton Friedman versus Larry Fink'.

In 1962, in *Capitalism and Freedom*, Friedman wrote:

There is one and only one social responsibility of business—to use its resources and engage in activities designed to increase its profits...⁷

Last year, in what has become known as 'Larry's letter' (referring to the annual letter Larry Fink, CEO of BlackRock, writes to other CEOs around the world) Larry Fink wrote:

Society is demanding that companies, both public and private, serve a social purpose. To prosper over time, every company must not only deliver financial performance, but also show how it makes a positive contribution to society. Companies must benefit all of their stakeholders, including shareholders, employees, customers, and the communities in which they operate.⁸

When this letter was written, we did not realize how much of an uproar it would create. However, thinking about the world we live in today, it would seem obvious that companies face different pressures than they did in 1962. As we have seen, the 'age of the internet' and the mindset of Millennials has changed the environment for businesses.

If you are not convinced of this, just think about how the '#MeToo movement' has changed views on sexual harassment. Or think about the 20,000 employees who walked out in protest at Google in November 2018. Finally, think about the employment numbers in the US and the current 'war for talent'. Should companies treat their employees well to retain talent, or should they act as if everyone is a cog in a wheel that can be quickly and easily replaced?

The discussion around sustainable investing has not been immune from this debate about profits versus purpose as voices argue whether consideration of ESG factors is a push for certain values or rather another factor that is a driver of shareholder value. Yet, it seems obvious that human capital management is an important aspect of managing companies. And this is just one example of sustainability.

Hopefully your takeaway from today's talk will be that we do not have a binary choice, and that due to broad and accelerating societal trends 'Profit AND Purpose' are increasingly symbiotic and aligned, particularly in regards to ESG.⁹

⁷ Milton Friedman, *Capitalism and Freedom* (1962).

⁸ Larry Fink's 2018 Letter to CEOs: A Sense of Purpose, available at <https://www.blackrock.com/corporate/investor-relations/2018-larry-fink-ceo-letter>.

⁹ For more on the alignment of profit and purpose see Larry Fink's 2019 Letter to CEOs: Purpose and Profit, available at <https://www.blackrock.com/corporate/investor-relations/larry-fink-ceo-letter>.

Regulatory Landscape

Regulation plays an important role in this discussion. To start, there are obvious regional differences in how to think about and how to approach ESG issues. For example, the EU is actively debating how far to go, contemplating everything from mandatory reporting, to requiring the inclusion of ESG criteria in investing, to defining a taxonomy around what it means to be 'green', and more. Meanwhile, the US has taken a less proactive approach, especially when it comes to prescriptive rules.

SEC Chairman Clayton raised issues related to disclosure and reporting at a recent Investor Advisory Committee meeting. In his own words:

...a key responsibility of the SEC is to ensure that the mix of information companies provide to investors facilitates well-informed decision making. The concepts of materiality, comparability, flexibility, efficiency and responsibility are the linchpins of our approach.

Chairman Clayton goes on to say:

*...companies should focus on providing material disclosure that a reasonable investor needs to make informed investment and voting decisions based on each company's particular facts and circumstances...*¹⁰

Similarly, IOSCO just issued a statement on ESG disclosures which stated issuers should provide "full, accurate, and timely disclosure of financial results, risks, and other information which is material to investors' decisions."¹¹

And, of course, the Department of Labor (DoL) weighed in this past year, particularly related to how collateral benefits relate to an investment advisors' fiduciary duty to its clients. In its Field Assistance Bulletin in April 2018, the DoL states:

...the Department reiterated its longstanding view that, because every investment necessarily causes a plan to forego other investment opportunities, plan fiduciaries are not permitted to sacrifice investment return or take on additional investment risk as a means of using plan investments to promote collateral social policy goals"

While this put many ESG proponents into a tailspin, the full guidance goes on to say:

*To the extent ESG factors, in fact, involve business risks or opportunities that are properly treated as economic considerations themselves in evaluating alternative investments, the weight given to those factors should also be appropriate to the relative level of risk and return involved compared to other relevant economic factors.*¹²

Which takes us to the heart of the debate.

¹⁰ Chairman Jay Clayton, "Remarks to the SEC Investor Advisory Committee", (Dec. 13, 2018), full remarks available at <https://www.sec.gov/news/speech/clayton-remarks-investor-advisory-committee-meeting-121318>.

¹⁰ See "MSCI ESG Focus Indexes" at <https://www.msci.com/msci-esg-focus-indexes>.

¹¹ IOSCO, "Statement on Disclosure of ESG Matters by Issuers", (Jan. 18 2019), available at <https://www.iosco.org/library/pubdocs/pdf/IOSCOPD619.pdf>.

¹² United States Department of Labor, Employee Benefits Security Administration, Field Assistance Bulletin No. 2018-01, (Apr. 23, 2018), available at <https://www.dol.gov/agencies/ebsa/employers-and-advisers/guidance/field-assistance-bulletins/2018-01>.

Investment Thesis: Value vs. Values

Are we talking about ‘value’ or ‘values’? Or as my fellow panelist this morning, Rob Sitkoff, calls them ‘Risk Return ESG’ or ‘Collateral Benefits ESG’?¹³

‘Values-based investing’ is a client-driven concept where the asset owner has a moral or ethical view such that a certain industry does not align with their values. These clients choose to specifically exclude (or include) investments based on the businesses companies are involved in. This approach has the potential to change what is included in the investible universe and hence incurs tracking error to traditional market benchmarks, both realities which investors understand and accept. A large swath of ESG style investment products and strategies continue to employ this approach.

‘Value-based investing’ is a quite different concept. Here, the investor accepts that insights into material governance, environmental, and social factors can be both positive and negative drivers of returns. This is an investment thesis, and not a moral or ethical perspective on companies. For example, a portfolio manager might choose to underweight tobacco companies due to concerns about regulation or reduced demand for cigarettes rather than a wholesale exclusion based on values.

As I mentioned earlier, the lack of agreement on definitions is part of the challenge in discussing and debating the topic of ESG investing, and the values versus value distinction is a prime example of that definitional challenge.

Yafit Cohn, Associate Group General Counsel at The Travelers Companies, expressed the definitional problem well at the same hearing where Chairman Clayton made the remarks I quoted earlier. She noted that “*ESG has been conflated with impact investing....and with corporate social responsibility*”. Having spent a year grappling to understand ESG data and ESG ratings, Yafit concluded:

*...ESG, at its core, refers to the risks and opportunities that could impact a company’s ability to create value over the long term – and how the company is managing those risks and taking advantage of those opportunities to ensure its long-term economic sustainability*¹⁴

We agree with this assessment. While ESG investing began years ago with values-based strategies, and some asset owners continue to pursue values-based strategies, a growing number of institutional investors are embracing ESG as they take a more investment-oriented or *value-based* approach. At BlackRock, we call this ‘*Sustainable Investing*’.

¹³ See Max M. Schanzenbach and Robert. H. Sitkoff, “The Law and Economics of Environmental, Social, and Governance Investing by a Fiduciary”, *Northwestern Law & Econ Research Paper No. 18-22*, (Jan. 2019).

¹⁴ United States Securities and Exchange Commission Investor Advisory Committee Meeting, Dec. 13, 2018. See full video recording of the meeting at https://www.sec.gov/video/webcast-archive-player.shtml?document_id=iac121318.

Understanding ESG Data

In order to use ESG factors to drive long-term value for our clients, it is important to have consistent, high quality ESG data. A key question then is what data should investors consider? And, of course, is this data available?

If you go back ten years, the answer would be unequivocally: 'No'. In fact, limited data was available, and the data that was available was of poor quality. However, a decade is a long time, and the data has clearly evolved and improved since then. Yafit pointed out in that same testimony that the ecosystem of for-profit and non-for-profit ESG-related entities is exploding. She tallied a total of 55 surveys and data verification requests that Travelers received from ESG rating organizations in just one year.¹⁵

At BlackRock, we recently created a spreadsheet to track 75 known providers of ESG data. These organizations include: MSCI, Sustainalytics, ISS, Morningstar, JUST Capital, Ceres, and the Carbon Disclosure Project (CDP). With this breadth of data providers, it is no wonder that companies are complaining about 'survey fatigue'.

While consistent, high quality data is important, the proliferation of data providers and rating agencies creates an expensive and wasteful situation where companies devote increasing resources for reporting and fact checking. Meanwhile, there is little agreement on which information is useful.

Unfortunately, the increased amount of work being done by corporates to answer this bewildering array of survey and data requests does not yet translate into consistently helpful information for investors. In fact, differing scoring systems produced by ESG rating agencies can create confusion as the scores can vary significantly for an individual company and an aggregate portfolio depending on whose standards are used. For example, Yafit cited the differing ratings for an unnamed peer of Travelers in the insurance sector: Sustainalytics scored them at 28.7%, while RobecoSAM scored them at 58% and CDP awarded them an A-.¹⁶ Clearly the proliferation of data providers, absent clearer standards and more consistent reporting, serves neither corporates nor investors particularly well.

Chairman Clayton noted that: "Each company, and each sector, has its own circumstances, which may or may not fit within a standard framework."¹⁷ This is an important insight, and it highlights the challenge for companies and investors alike.

Two of the frameworks we find most useful are:

- **TFCD**, which has created a flexible framework for disclosure. While it is intended for climate-related disclosure, the framework can be applied to other environmental and social factors as well.
- And **SASB** which has taken an industry-specific approach with a focus on material financial issues.

¹⁵ Ibid.

¹⁶ See Footnote 14.

¹⁷ See Footnote 10.

Given the importance of these factors, the time has come for standard setters to come together. Otherwise, investors need to lead the way by coalescing around a set of standards. While we understand concerns that the data is far from perfect, we also believe significant investment insights can be gained from the data that is available today.

At BlackRock, we break ESG data into three main categories:

1. **Company disclosure.** As I noted earlier, an increasing number of companies are disclosing more ESG data either for regulatory reasons or in response to social pressure. While this information is still incomplete and often lacks standardization, there is definitely more data to consider, which was not the case a decade ago.
2. **ESG data providers.** The various providers start with company disclosures and then do additional research, find other sources, interpret the data, and add a subjective lens. While the ratings vary, understanding their methodology and looking beyond the headlines to understanding the components provides useful insights. For example, MSCI and Sustainalytics each have hundreds of research analysts who aggregate thousands of ESG data points which are weighted into 'G', 'E', and 'S' pillars, and then rolled into a single ESG headline score.¹⁸
3. **Big data approaches.** New techniques are available to source and analyze large data sets. Whether it is data we inadvertently leave on-line, or it is deliberately written evaluations, this is yet another source of ESG information. For example, in a world where human capital management reflects the importance of employees as stakeholders, mining GlassDoor for employee sentiment data provides useful insight into a company's human capital management practices.

Investors need to recognize that relevant ESG data changes over time. For example, the focus on cyber risks and data privacy – which are often considered under the Social pillar – are relatively recent. To put this in perspective, MSCI downgraded Equifax to CCC in 2016 based on weakness in this area. This downgrade preceded the Equifax data breach.¹⁹

Integrating ESG Factors

At BlackRock, we believe governance, environmental and social factors are important to the long-term financial performance of companies. Once again, we find ourselves in synch with Yafit as we think of these factors as both risks and opportunities. We are committed to identifying data that is material to companies, and incorporating this data into our decision process. We define 'ESG Integration' as the practice of incorporating *financially material* ESG information into investment decisions to enhance risk-adjusted returns. Importantly, ESG integration is not a values-based exercise.

¹⁸ More information on MSCI ESG scoring available at <https://www.msci.com/esg-ratings>; and more information on Sustainalytics ESG scoring available at <https://www.sustainalytics.com/esg-ratings/>.

¹⁹ See "MSCI ESG Ratings May Help Identify Warning Signs", MSCI, available at <https://www.msci.com/documents/1296102/6174917/MSCI-ESG-Ratings-Equifax.pdf/b95045f2-5470-bd51-8844-717dab9808b9>.

Over the past few years, BlackRock has begun integrating ESG factors into our investment platform. Today we offer sustainable investment products across asset classes, including equity, fixed income, cash, and real estate and insurance.²⁰ Following are a few examples of ESG integration at BlackRock:

1. BlackRock's Fundamental Active Equity (FAE) team, created an ESG Risk Window which identifies what this team believes to be the most relevant sector-specific ESG risk metrics for a given issuer with the goal of highlighting and better understanding if and how a company is managing those risks.
2. BlackRock's Emerging Markets Debt (EMD) team uses an emerging markets corporate ESG Scorecard which they feed into their standard corporate credit analysis. The analysts on this team believe that the management and progress in specific ESG metrics can signal credit quality of emerging markets issuers and that this is underappreciated by the market today.
3. BlackRock's Cash team has constructed its own proprietary 'responsible cash' metric built off a set of the most material key performance indicators (KPIs) for their asset class. This team now includes this factor in its investment committee decision-making process for corporate issuers.²¹
4. BlackRock's Real Assets team uses a proprietary ESG investment questionnaire to highlight ESG risks for further discussion with the relevant investment committees. Given the nature of investing in long-term, physical assets, this team believes that poor performance in specific ESG areas represents a material risk to the investment thesis. The Real Assets team incorporates relevant ESG requirements into the contracts of third party vendors and managers to help ensure they minimize these risks by operating in line with relevant ESG requirements and good industry practices.

Investment Stewardship

Larry's letter also highlighted the importance of investment stewardship, especially in index portfolios which provide long-term capital to thousands of companies. As with ESG Integration, investment stewardship is not about making 'social decisions' with our clients' money, nor is it about imposing 'values' on companies. Rather, investment stewardship is about maximizing long-term value. Our engagement emphasizes issues that we believe have a material impact on a specific company.

In our stewardship activities, we prefer to engage first to build a dialogue with a company rather than surprise them with a negative vote. We also believe engagement leads to more informed voting than simply following the recommendations of a proxy advisor.

Of course, it's easy to measure voting and compare across managers – which many people do. We caution, however, that voting is only one aspect of investment stewardship. As part of our commitment to being transparent, we publish on our website: engagement priorities, voting guidelines, bulletins and commentaries on selective issues, quarterly regional reports, global annual report, and actual voting data. And this morning we just rolled out an upgraded site with

²⁰ See more about BlackRock Sustainable investing at <https://www.blackrock.com/ch/individual/en/themes/sustainable-investing>.

²¹ On January 22, 2019, BlackRock announced its intention to launch an environmentally-aware money market fund called the BlackRock Liquid Environmentally Aware Fund ("LEAF"). See more in our press release at <https://www.businesswire.com/news/home/20190122005937/en/>.

improved navigability.²² I encourage you to look at our website to get a better understanding of the issues we are focused on and actual engagement outcomes.

Our approach is very much aligned with Chairman Clayton's stated view that:

...asset managers who are required to vote in the best interest of their clients – should also focus on each company's particular facts and circumstances...Advisers cannot put their own interests ahead of the interests of their clients...²³

...even on ESG matters.

Client Perspectives on Sustainable Investing

A discussion of sustainable investing would not be complete without touching on the asset owner role in investing. Asset managers act as fiduciaries, investing on behalf of asset owners, whom I will refer to here as the 'clients'.

Client motivations in the ESG space fall into one of two categories: 'avoid' or 'advance'. As mentioned earlier, you can think of 'avoid' as exclusionary screens (e.g. tobacco, fossil fuels, defense) that reflect the social values of the client.

'Advance', on the other hand, is both broader and more nuanced, and we identify three sub-categories:

1. **ESG** – These are portfolios optimized around ESG ratings to produce a broadly exposed portfolio with better than average ESG scores. For example, we worked with MSCI to develop the MSCI Focus Series which has produced a tighter tracking error to the mother index compared to the MSCI Leader Series.²⁴
2. **THEMATIC** – These are portfolios designed to emphasize a specific positive environmental or social goal. For example, investing in companies or projects focused on wind and solar energy.
3. **IMPACT** – These are portfolios targeting a specific sustainable outcome alongside financial return. For example, 'green bonds' have emerged as a new asset class which allows investors to direct monies toward environmentally friendly projects while still having traditional fixed income financial exposure.

²² See BlackRock Investment Stewardship's website at <https://www.blackrock.com/corporate/about-us/investment-stewardship>.

²³ Chairman Jay Clayton, "Remarks to the SEC Investor Advisory Committee", (Dec. 13, 2018), full remarks available at <https://www.sec.gov/news/speech/clayton-remarks-investor-advisory-committee-meeting-121318>.

²⁴ See "MSCI ESG Focus Indexes" at <https://www.msci.com/msci-esg-focus-indexes>.

Conclusion

The landscape for ESG investing is a dynamic one. In the last decade or so there has been dramatic progress made in advancing the field from a ‘values-based’ exercise to a ‘value-driven’ approach that holds promise for combining the ability to ‘do well’ while also ‘doing good’. While there is room for further development and improvement in the realm of ESG data, these challenges have not stopped asset managers and investors alike from pursuing sustainable investing options with real results.²⁵ ESG is one area in asset management that has great potential to shape the industry as we know it today as well as to be a manifest link between purpose and profits in corporate America.

²⁵ See more on BlackRock’s approach to sustainable investing in “Sustainability: The future of investing” (Jan. 2019), available at <https://www.blackrock.com/corporate/literature/whitepaper/bii-sustainability-future-investing-jan-2019.pdf>; “Sustainable investing: a ‘why not’ moment – Environmental, social and governance investing insights” (May 2018), available at <https://www.blackrock.com/corporate/literature/whitepaper/bii-sustainable-investing-may-2018-international.pdf>; and “What is sustainable investing?”, available at <https://www.ishares.com/us/strategies/sustainable-investing>.

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