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Municipal Finance Law Since 1971

ESG: It's About Risk Management.

An increasing number of investors are interested in strategies that offer opportunities to make positive impacts on environmental, social and governance (ESG) issues that they care about while also earning attractive financial returns. Investors who consider the impact of a security issuer's ESG-related practices and policies gain a more complete view of the risks posed by poor governance. By recognizing these sources of risk, they increase their likelihood of achieving the positive outcomes they seek.

We believe impact investing plays a critical role in helping create a world where both people and communities can flourish. Thriving communities depend on clean air and water, access to quality education and equal protection under the law. Unfortunately these public goods are often taken for granted and only noticed when they fail, such as when the mismanagement of Flint, Michigan's water system exposed 100,000 people to potential poisoning. Flint's fall from industrial powerhouse to one of the poorest communities in America is about much more than just economics – it was a failure of governance and stewardship of public goods. This is one of many examples of how poor governance can lead to environmental and social challenges that face communities today.

Even more frequently overlooked than the role that environmental, social and governance (ESG) factors play in a community's quality of life is the role that they play in managing risk in investment portfolios. While traditional investment analysis has paid relatively little attention to these non-financial sources of risk, we believe that failure to integrate analysis of ESG factors into the investment decision-making process overlooks the potential effect of these non-financial factors on investment performance, particularly over the long term.

Unethical or neglectful behavior by a government or a company in an area of environmental, social or governance concern can harm those who invest in that government's bond or company's stock as well as harming the environment or community where a company or government is located.Investors in these communities and companies often underrate the seriousness of these risks to their investment process.

Risky Business
Each asset class creates its own set of risks and opportunities. Sometimes the risks for investors from ESG-related issues are direct and obvious. Volkswagen's use of software in its diesel cars to cheat on emission tests is an example of poor corporate governance leading directly to environmental and financial harm. That failure of governance allowed elevated levels of unhealthful oxides of nitrogen emissions into the air as well as exposing the company and its shareholders to potential lawsuits and fines by regulators. Unsurprisingly the company's stock price has suffered. The harm resulting from poor governance also extended to many unrelated areas of the automotive industry, as other companies found themselves facing increased scrutiny of the sector from regulators.

Not all ESG-related risk arises from lack of governance. A far more common outcome is the underestimation of a security or sector's long-term risks and the subsequent overestimation of its value. By not considering non-financial risks that may take years to materialize, analysts implicitly

place greater emphasis on the short-term financial circumstances of a company or government when determining the value of a potential investment. That focus on an issuer's attractive short-term financial prognosis may be reflected in stock or bond prices that are higher than they would be if the significant long-term non-financial risks facing the issuer were understood and properly priced in.

Turning Impact Interest Into Implementation

The number of investors who are interested in making a positive impact with their investment portfolio continues to grow every year. With that growth we get closer to a world where impact investing and investing are the same thing. So how does the investment community turn this momentum into implementation? It starts by each investor understanding that EVERY portfolio makes an impact. Some investors want their portfolios to make an impact on environmental issues such as fighting climate change or on social issues including ensuring gender diversity on corporate boards. Others want the impact to be maximizing return on investment. While investment goals and impact are unique to each client, all share in the need to manage risk with relevant data. All investors want to be fully informed and aware of the risks they face with each investment. Are you ignoring any risks in your investment portfolio that may affect your outcomes? Using ESG Integration to solidify risk metrics is timely for all types of investors everywhere.

Disregarding valuable data for environmental, social and governance considerations inevitably increases the potential risks in a portfolio. Integrating analysis of these factors into the investment decision-making process creates a more accurate understanding of risk as well as a deeper understanding of each client's unique impact goals. Integration of these factors leads to more informed investment decisions and impacts for both advisors and individual investors strengthens client relationships, and builds resilient communities.

ESG Around The World

As we work to push ESG integration and impact investment principles into the mainstream of investment philosophies in the U.S., we can look abroad to see what such an investment landscape could look like. International investors establish the need for esg integration upfront by asking asset managers and investment advisors how they are integrating these factors into investment frameworks. That long-standing interest, combined with regulations such as the UK's Stewardship Code has created an environment in most developed markets where investors expect managers to not just demonstrate familiarity with the role that ESG factors play in investing, but to have integrated management of these factors into the way they manage portfolios. Since 2006, the United Nations Principles for Responsible Investment have codified the principle that Environmental, Social, and Governance ("ESG") factors can have a meaningful impact on the risk and return profile of fixed income investments. Meanwhile, interest among U.S. investors in these approaches to portfolio management has been slower to develop but is now rising quickly.

What it Means for Muni Bonds

While many ESG integration strategies focus on equities and use proxy-voting rights to press firms to improve their policies, ESG integration should be an important part of fixed income investment decision making as well. Indeed, selecting municipal bonds for inclusion in a portfolio requires implicit consideration of at least some environmental, social and governance factors. Munis exist due to the need to fund public goods and while traditional bond analysis looks primarily at credit risk, the quality of an issuer's governance should be an integral part of that analysis. Sustainable bond issuers typically exhibit best practices in the areas of timely and transparent budgeting, strong financial controls, good management of pension liabilities and emphasis on delivering essential services such as school construction and water and sewer systems. Incorporating these issues enables a more comprehensive understanding of broader risk factors over time and a better understanding of whether a bond's pricing accurately reflect risks over the bond's full duration.

Municipal finance provides a critical window into important ESG-related risks such as public health, safety and the scarcity and sustainability of natural resources and human capital.

So how can you help?
Impact-oriented investors want their investments to make positive contributions to the places and causes that they care about. All investors want the ability to utilize relevant data to be informed of all the risks they face while finding undervalued investment opportunities. The great news is that ESG integration is a powerful tool that help guide decision making for each investor today.

We believe investment advisors play a critical role in helping build a better world by being leaders in advancing the impact investing movement. Do you have questions about incorporating ESG analysis into your investment process? Send us an email at investors@neighborly.com or sign up here to learn more.

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