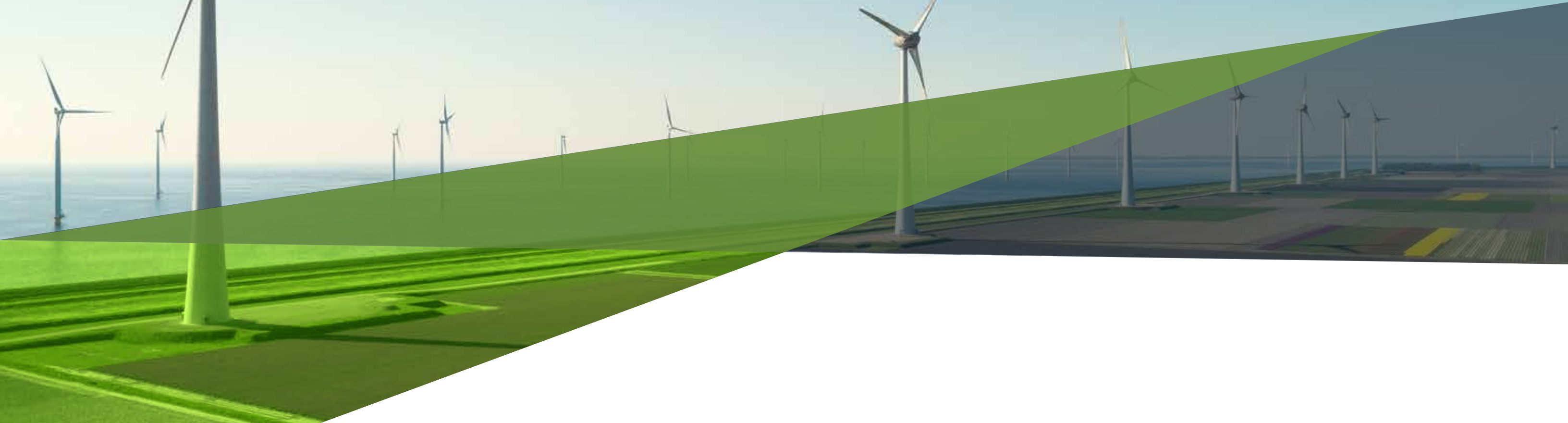

FIDELITY INSTITUTIONAL INSIGHTS

Sustainable Investing for Advisors: Having Better Conversations with Clients

With interest in ESG surging, advisors can benefit when they engage with investors about their values and goals.

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KEY TAKEAWAYS

- Interest in sustainable investing and ESG has surged in recent years, and the number of conventional funds that consider ESG factors has increased commensurately. Yet, advisors have arguably been slow to offer sustainable investment options to their clients.
- Some advisors have been tentative in their approach to sustainable investing because they are unaccustomed to having values conversations with clients and are uncertain about what investment solutions will meet their clients' needs.
- While there are multiple approaches and strategies associated with sustainable investing, the common goal is to enable investors to incorporate material ESG factors while achieving their investment objectives.
- Fidelity's four "ESG mindsets" can help advisors understand their clients' motivations for pursuing ESG as a path to sustainable investing, and guide them to have more productive, meaningful, and engaging client conversations.

Interest in incorporating environmental, social, and governance (ESG) factors into investment considerations has never been higher. Whether in equities, open-ended mutual funds, or exchange traded funds, products focused on ESG have exploded in recent years. According to Morningstar, flows into sustainable funds totaled $21.4 billion in 2019, a nearly fourfold increase over the previous calendar-year record, which was set in 2018.[1] In addition, the number of conventional funds that say they consider ESG factors has also grown exponentially, from 81 funds in 2018 to 564 in 2019.[2] And this elevated demand began prior to the COVID-19 crisis, which may increase investor scrutiny into material matters related to health care, worker safety and compensation, and other interrelated issues.

Fidelity's ESG Investor Mindsets

- Impact Seeker
- Alignment Seeker
- Expression Seeker
- Security Seeker

Source: Fidelity Investments

Despite this dramatic increase in interest in sustainable funds, some advisors have been slow to embrace the trend: Although the majority of investors working with a financial professional say they have positive perceptions of sustainable investing and ESG, only 36% of advisors offered sustainable investment options to their clients in 2018.[3]

It is against this backdrop that more and more advisors are considering whether to add sustainable investing solutions to their service options. Yet, even as they begin to recognize the potential benefits of addressing this growing investor demand, many advisors face the dual obstacles of not knowing how to engage clients on the intricacies of ESG and not having investment solutions at the ready when they do.

This article defines and clarifies sustainable investing for advisors, presents the evolving opportunities and challenges, and addresses some of the key nuances to help advisors put ESG into context within today's wealth management landscape. Additionally, it describes four ESG investor mindsets based on original Fidelity research. These behavioral archetypes can help advisors understand their clients' motivations around ESG and sustainable investing and guide them to have more productive, meaningful, and engaging client conversations.

What is Sustainable Investing?

While sustainable investing encompasses varying terms and methodologies, Fidelity defines it as an investment discipline that incorporates ESG factors into an investment approach or decision-making process. For instance, many investors are interested in supporting companies with sound environmental practices, labor policies, diversity initiatives, and corporate governance. A sustainable investing approach rooted in ESG analysis provides a way for them to direct their investments in support of their ideals related to these consequential issues.

While the origins of sustainable investing include approaches such as socially responsible investing (SRI), which has an exclusionary aspect and still exists today, an important development in the field of sustainable investing is the focus on "material" ESG factors that impact a firm's earnings potential and valuation in a positive or negative way. For instance, fair labor practices and supply chain management may be considered material for a garment manufacturer, while data privacy and cybersecurity are material for many companies in technology, health care, and financial services. Materiality matters because it calls for companies to manage (and investors to measure) ESG factors that are relevant within their sector and are most likely to impact financial performance and shareholder value and possibly reduce risk for investors.

Materiality and Sustainable Investing

The Sustainability Accounting Standards Board (SASB) defines financially material issues as those that are reasonably likely to impact the financial condition or operating performance of a company and therefore are most important for investors.

Source: The Sustainability Accounting Standards Board

Beyond the Acronym: Environmental, Social, and Governance

Sustainable investing integrates three ESG factors into investment research and decision-making (Exhibit 1):

Environmental

Investing in companies that are responding to consumer demand for sustainable practices or are focused on delivering innovative solutions such as renewable energy. Factors considered may include emission standards and carbon footprint, conservation of natural resources, and/or ethical management of livestock.

Social

Investing in companies that aim to do right by the many stakeholders they serve, including customers, employees, suppliers, and their communities. Factors considered may include how a company ensures safe conditions for workers globally, commits to a diverse and inclusive workplace, protects customer data, and responds to the needs of surrounding communities.

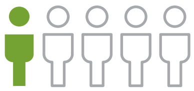
Governance

Investing in companies committed to incorporating best-in-class corporate governance practices. Factors may include board composition and oversight, management incentives, proper corporate reporting, and shareholder-friendly capital allocation policies.

EXHIBIT 1: In sustainable investing, portfolio managers evaluate ESG metrics alongside traditional financial analysis.

Environmental Sustainability and resource efficiency	**Social** More equitable societies and respect for human rights	**Governance** Accountable governance and transparent operations
Climate Change	Labor Standards, Health, and Safety	Executive Incentive Structure
Greenhouse Gas Emissions	Fair Treatment of Minorities	Board Diversity and Independence
Resource Depletion	Diversity, Employee Engagement	Transparency and Disclosure
Waste and Pollution	Supply Chain Management	Lobbying/Political Contributions
Energy Efficiency	Local Community Impact	Bribery and Corruption
Alternative Energy	Data Protection/Privacy	Business Ethics

Source: Fidelity Investments



1 in 5 investors are willing to pay more for an advisor who offers more socially responsible or ESG-based investing strategies.[4]

Why Should Advisors Care about Sustainable Investing and ESG?

One study found that a majority of investors (79%) say they "love the idea of investing in a company that cares about the same issues that they do." A similar percentage (74%) believe ESG-based investments represent "a strategy they can feel good about and one that makes long-term financial sense."[5] And Fidelity found that 1 in 5 investors—and over a third of Gen XYZ investors—are willing to pay more for an advisor who offers more socially responsible or ESG-based investing strategies.[6] In other words, advisors should consider where ESG practices fit into their advice offerings because it may be what many of their clients want. In addition, a sustainable investing approach can have a positive impact on the advisor/client relationship by helping advisors deliver benefits along a number of different dimensions:

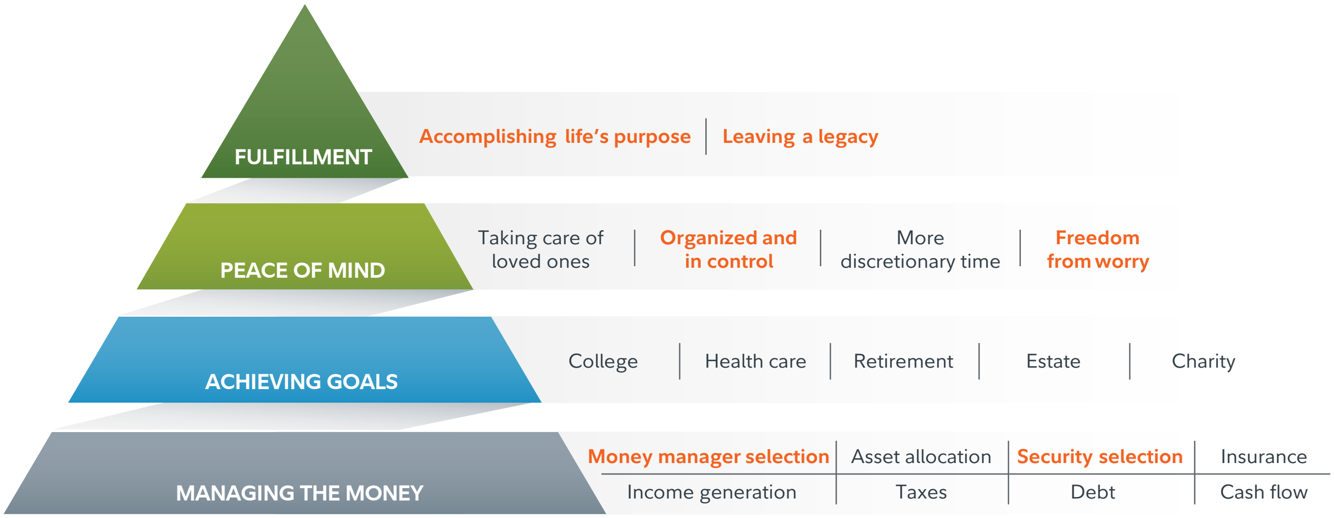
Fostering a meaningful client experience

Conversations around sustainable investing and ESG can help advisors deepen relationships with clients and differentiate themselves from other firms. Discussing values, for instance, and actively listening to learn what issues matter most to clients, can help advisors ensure the plans they develop reflect their clients' holistic goals. In addition, values conversations with clients may bolster an advisor's potential for receiving referrals. For instance, a 2019 study by Fidelity that used Net Promoter Score™ to gauge the strength of client-advisor relationships in wealth management found that 86% of promoters (individuals more likely to provide a recommendation) say their advisor "considers my unique needs/goals/preferences," and 91% of promoters say their advisor "understands my life situation/stage and advises appropriately."[7]

Delivering more value

Fidelity introduced the Advice Value Stack® framework to help advisors add greater value to clients by serving them based on their most important needs. Inspired by Bain & Company's "Elements of Value,"[8] the Advice Value Stack suggests that advisors can add value in multiple ways: managing their clients' money, helping clients achieve diverse financial planning goals, and even ultimately helping them attain peace of mind and reach fulfillment—a sense that they have accomplished their life's purpose and are leaving a legacy. As Exhibit 2 illustrates, an ESG perspective is applicable along several key touch points and across multiple levels of the Advice Value Stack. As part of that, ESG discussions can serve as a starting point to help advisors work with clients to identify possible ways to increase their impact on the people, places, and issues they care about.

EXHIBIT 2: ESG touch points* appear across multiple levels of Fidelity's Advice Value Stack®



Source: Fidelity Investments. * A sustainable investing approach that incorporates ESG factors can help deliver the "elements of value" marked in orange. These elements are key areas where clients may find the most benefit from advisory services.

A means to potentially help mitigate risk

Including ESG considerations in the investment selection process can arguably help clients avoid investor fallout and related risk resulting from poor corporate citizenship and/or legal, ethical, or financial missteps by executives and organizations. For example, a 2019 research report on the performance of ESG-based investment strategies by Bank of America concluded that "ESG is a better signal of earnings risk than any other metric that we have found."[9] In addition, according to a report by Nordea Equity Research, strong ESG performance contributes to risk mitigation on several levels. For example, the report concluded that ESG ratings mitigate reputational risk and can be "a leading indicator of future earnings stability and a predictor of share price volatility," as well as "a good proxy for future operational performance."[10]

Sustainable and Values-Aligned Investment Approaches

With sustainable investing, ESG factors inform how the approach is implemented, managed, and measured. According to the Money Management Institute and The Investment Integration Project (TIIP), investors act on their sustainable investment goals in three ways that can be characterized as Avoid, Emphasize, and Engage.[11] Building on this taxonomy, the following are some of the approaches investors with an interest in ESG can put into practice:

Avoid

- *Negative screening* avoids companies with poor ESG performance, or those that disregard widely accepted ESG norms or standards. *Exclusionary screening* avoids entire sectors or industries an investor deems unacceptable based on ESG factors. To some investors, this may mean divesting or excluding investment in companies or industries with primary interests in, for example, tobacco, weapons, or fossil fuels.

Emphasize

- *Thematic investing* pursues market exposure to specific long-term themes tied to sustainability and ESG. This approach can help investors target sectors or topics (e.g., gender diversity or renewable energy), act on their views, and "personalize" their portfolios to include more investments that align with their beliefs and interests.
- *Impact investing* targets investments in sectors or companies with the intention to achieve specific social or environmental impact that can be measured, such as access to clean water or an increase in affordable housing. It may also involve active engagement with companies by shareholders to produce measurable improvement on ESG issues.
- *ESG integration* incorporates ESG factors explicitly into investment decisions to help better identify risks and opportunities. In this case, the investment fund or product is not focused on a single theme. Rather, it is looking at both the fundamental and ESG characteristics at the same time.

Engage

- *Shareholder advocacy* includes engaging with company management in dialogue and shareholder resolutions around ESG factors.
- *Proxy voting* involves engaging with management through voting on proposals brought before shareholders at annual and special meetings, and using the vote to elevate the principles of ESG within the organization.

Keep in mind that all approaches are not automatically mutually exclusive, but rather they represent various strategies investors can consider to achieve their investment objectives with an ESG lens.

Fidelity's ESG Investor Mindsets

One of the reasons some advisors don't broach the topic of sustainable investing and ESG with clients may be a lack of fluency in exploring their clients' values and the extent to which they want those values to be reflected in their investments. Fidelity has conducted qualitative research to better understand investors' objectives when it comes to sustainability and ESG factors. As part of that work, Fidelity discovered four unique ESG mindsets (Exhibit 3) that reflect how investors think about sustainability and ESG practices. These mindsets are archetypes that can help advisors understand their clients' motivations for sustainable and values-based investing—and create a tangible basis for productive and engaging client conversations. For example:

- **Impact seekers** want to invest their money to make a measurable impact in the world. They focus their investments on specific issues where they can have tangible influence. They want evidence that proves they are benefitting the causes they care about.
- **Alignment seekers** want their investments to align with the causes they support. They don't want to invest in companies that profit from doing harm. These investors may sleep better at night knowing they are investing in ways that align with their values.
- **Expression seekers** want their investments to make a statement about issues that are important to them. They prefer to avoid entire industries that they consider unethical. They want to help reward the "good" companies and punish the ones they consider "bad."
- **Security seekers** want their investments to secure their financial future and are wary of making changes based on non-financial factors. They would not change their investments simply to support causes—they believe there are other ways to do that. They will only consider these issues if they can help to improve financial returns.

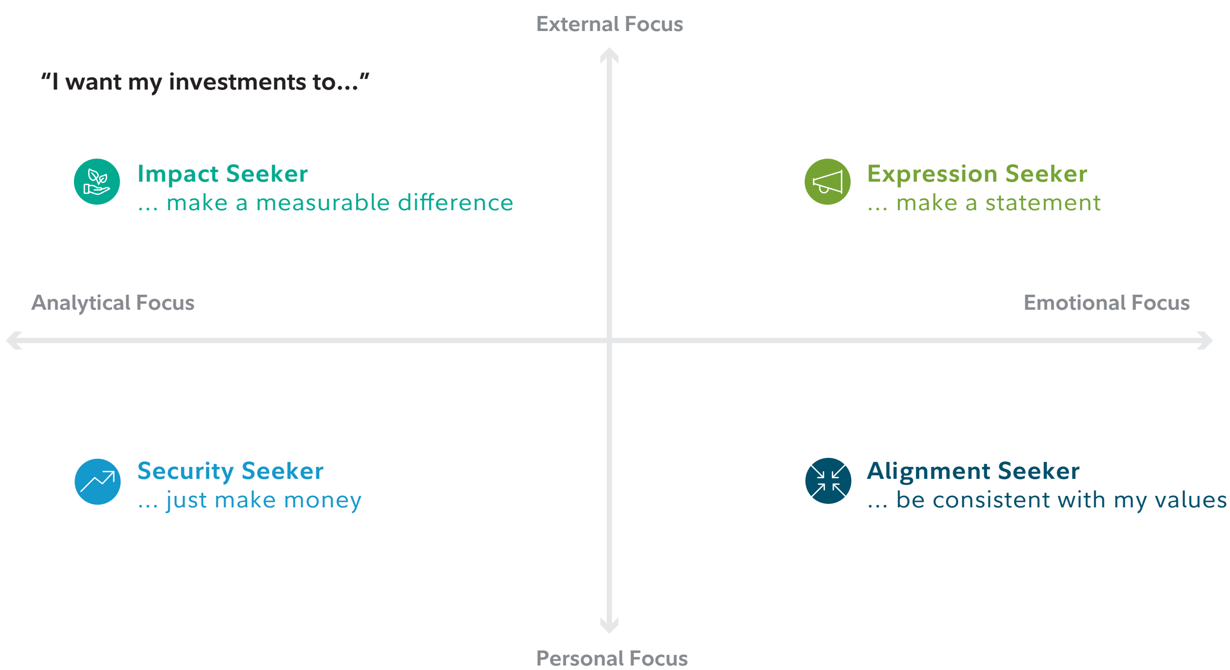
As part of our work developing these mindsets, Fidelity found that there are two specific variables that help explain and define client motivations around sustainability and ESG.

The first variable is whether an investor thinks about impact through an external-facing lens or more of an internal and personal lens. For instance, are they primarily thinking about the impact their investments can have on the outside world (decreasing world hunger or supporting clean technology)? Or, are they thinking about how their investments will provide security and peace of mind for themselves and their family?

The second variable is whether an investor thinks about ESG and its desired impact in an emotional or an analytical way. For instance, are they driven to advocate on behalf of their social beliefs in order to achieve peace of mind? Or, do they seek specific, measurable outcomes, such as increasing the number of female CEOs or avoiding drawdowns caused by corporate scandals?

Fidelity's four ESG mindsets can give advisors a fundamental understanding of how clients feel about sustainable investing and ESG, and help them get to know client motivations. They can also help advisors anticipate and navigate challenging discussions around topics such as corporate scandals in the news, a fund's proxy voting history, or the impact of divestment.

EXHIBIT 3: Fidelity's ESG Mindsets Can Help Advisors Understand Their Client's Motivation around Sustainable Investing and ESG, Allowing Them to Tailor Their Conversations to Be More Meaningful and Relevant



Source: Fidelity Investments

Navigating ESG Challenges

Applying an ESG lens to an investing approach can mean different things to different people, making it important for advisors and their firms to have a clear definition and a preferred approach. Even beyond aligning how we think about and define ESG, these are a few of the other challenges that advisors should be aware of as they begin to introduce ESG options:

Tricky conversations

It's tough to talk about values. Advisors may not always know where to begin and/or how to avoid the "political" and cultural landmines that come with discussing a client's specific ESG orientation and priorities. The ESG mindsets explored in this article are intended to create a framework to help advisors understand investors' objectives and have informed conversations about aligning values and investments.

Due diligence and greenwashing awareness

Advisors must do the requisite research in order to help clients make the types of investments they feel good about while also helping them achieve their financial goals. As part of that, advisors need to be careful of "greenwashing"—when corporations (and asset managers) misrepresent their ESG standards, possibly making themselves look more sustainable than they really are. As demand for sustainable investing grows, so too does the need for high-quality data and a screening process that measures sustainable credentials correctly and consistently. It's important for advisors to do their own due diligence on funds that market themselves as "sustainable" or companies that proport to be committed to ESG policies and practices. In the meantime, governments are increasingly pushing for tighter ESG regulation in the form of taxonomies and standard disclosures.

Measurement and reporting standards

An organization's ESG ranking—or their "ESG score"—is based not only on social/environmental impact (e.g., carbon emissions), but also on whether or not they have formalized ESG-related policies (e.g., workforce diversity policy). But unlike financial returns, which can be measured through corporate balance sheets and standardized reporting statements, for the time being ESG reporting is voluntary and not measured using any one standard or established metric.

Breaking past the performance myth

The assumption that sustainable investment strategies always sacrifice returns is an idea that has been called into question. In fact, one 2015 meta study demonstrated that ESG factors have no definitive systematic performance advantage or disadvantage.[12] In addition, a seminal study from Harvard Business School found that investments in material sustainability issues by companies are shareholder-value enhancing and even non-material sustainability investments by companies are "at a minimum not value-destroying."[13]

Talking to Clients about Sustainable Investing and ESG

Engaging with clients about sustainable investing begins with gaining enough knowledge about the topic and landscape to offer the expertise they need. The insights here will help provide that knowledge. In addition, advisors need to be prepared to customize the conversation. For example:

1. Understand what clients care about

The more familiar advisors are with the issues that are most meaningful to their clients, the easier it will be to talk about values-aligned investment strategies, including ESG. It's not a one-time conversation, but an ongoing part of a deepening relationship with clients. Conversations starters can include:

- What types of philanthropies or charities mean the most to you?
- Are there social issues that are important to you and your family?
- Are there key characteristics you look for in the companies you do business with?
- Assuming you could meet all of your financial goals—what else would be important in your investments?

2. Know their mindset

Knowing which ESG mindset a client has can help advisors customize their advice. It can also help them introduce sustainable investing in a way that's engaging and well received, because their language and advice will be more aligned with how their client thinks and what they want to achieve. For instance, here are some ways to position investment conversations for each of the ESG mindsets:

Impact Seeker

- It is possible to make an impact at scale.
- Investment managers that adopt ESG practices can influence companies to change their behavior through direct engagement and proxy voting.

Alignment Seeker

- You can invest in companies that align with the positive causes you support.
- An investment manager that follows ESG practices can avoid the "worst of the worst" by selecting companies with the best Environmental, Social, and Governance profiles in each sector.

Expression Seeker

- You can choose funds run by investment managers who share your views and who exclude industries that don't align with your values.
- You can participate in the global sustainable investing movement.

Security Seeker

- ESG is just another data point to help us make the best investment decisions. It can help us quantify the intangible aspects of a company.
- We can integrate ESG data with traditional financial data to uncover hidden risks.

Charitable Giving and ESG

Discussing charitable giving can be a natural way to uncover client values. After all, many will have charitable causes they support regularly, and some may already embrace charitable or philanthropic goals. In addition, a charitable giving vehicle such as a donor-advised fund can provide a natural starting point for implementing a sustainable or impact-investing strategy with a client. For many clients, these investment strategies will enable them to deploy more of their philanthropic assets in a way that aligns with the impact they seek to have.

Action items

- Become familiar with ESG and the sustainable investment landscape, including evolution, approaches, and performance trends.
- Start talking to clients about their ESG preferences.
- Add sustainable investment and ESG questions to your client questionnaire and customer database to begin to understand where your clients stand.
- Run through each ESG mindset type: What mindset do you and your firm have? Can you imagine offering multiple investment strategies based on your clients' mindsets? What are the challenges for your firm?
- Develop a process for assessing ESG factors and building sustainable investment strategies designed to serve your clients' interests.
- Consider options for outsourcing sustainable investing in order to give clients an opportunity to integrate ESG considerations in part of their portfolio.

Authors

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Rick is the head of ESG Pro, a technology solution that helps advisors start and grow their ESG investing practice. ESG Pro combines ESG model construction tools and client experience tools in one end-to-end solution. Rick has 20 years of experience in financial services and has worked on innovation projects across multiple Fidelity business units, including Asset Management, Institutional Investing, Workplace Investing, Personal Investing, and Health Care.

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Endnotes

1. Morningstar Sustainable Funds U.S. Landscape Report, February 14, 2020. **2.** IBID. **3.** The Fourth Annual Responsible Investing Survey, Nuveen, 2018, https://www.nuveen.com/en-us/thinking/responsible-investing/fourth-annual-responsible-investing-survey. **4.** The 2019 Fidelity Investor Insights Study was an online, blind study conducted from August 6 through August 26, 2019. It involved a total of 2,026 25-minute (on average) online interviews, with the sample provided by Brookmark, a third-party research firm not affiliated with Fidelity. The study was focused on understanding affluent investors' attitudes, goals, behaviors, and preferences related to investing, wealth management, and advice. Target sample included respondents across affluence levels, from $50,000 to more than $10 million in total investable assets, excluding any real estate or investments in 401(k), 403(b), pensions, or other employer-sponsored retirement plans. **5.** ESG, Ethics, and Investing, Allianz, May 2019. https://www.allianzlife.com/-/media/files/allianz/pdfs/esg-white-paper.pdf?la=en&hash=1DE90B73C82847769EAB94B29A819834E8984C6F **6.** 2019 Fidelity Investor Insights Study. **7.** Data from the 2019 Fidelity Investor Insights Study. Net Promoter®, Net Promoter System®, Net Promoter Score®, and NPS® are registered trademarks of Bain & Company, Inc., Fred Reichheld, and Satmetrix Systems, Inc. **8.** Eric Almquist, Bain & Company, "The Elements of Value," *Harvard Business Review*, September 2016, https://hbr.org/2016/09/the-elementsof-value. **9.** ESG Matters—US, BofA/Merril Lynch Global Research, September 2019. **10.** Strategy & Quant, Nordea Equity Research, September 5, 2017, https://nordeamarkets.com/wp-content/uploads/2017/09/Strategy-and-quant_executive-summary_050917.pdf. **11.** William Burckart and Jessica Ziegler, The Fundamentals of Sustainable Investment, The Investment Integration Project (TIIP), 2019. **12.** G. Friede, T. Busch, and A. Bassen, ESG and Financial Performance: Aggregated Evidence From More Than 2000 Empirical Studies, *Journal of Sustainable Finance & Investment*, 2015, Vol. 5, No. 4, P. 221. **13.** Mozaffar Khan, George Serafeim, and Aaron Yoon, Corporate Sustainability: First Evidence on Materiality, *The Accounting Review*, November 2016, Vol. 91, No. 6, pp. 1697–1724.

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