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SUSTAINABLE INVESTING YEAR IN REVIEW

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> Increasingly more people realize that their sustainability concerns can be address through their investments. As more investors embark on the sustainable investing journey—learn what it is, why one pursues it, and how to do it—assets into sustainable funds will continue and investors will have more choices from which to construct sustainable investing portfolios.

Individuals and institutions are increasingly concerned about sustainability issues. A World Economic Forum survey from the fall of 2020 concluded that 79% of American respondents agreed with the following statement: "I want the world to change significantly and become more sustainable and equitable rather than returning to how it was before the COVID-19 crisis." We take a look at the growth of investor interest in sustainable investing while answering some common questions about it.

WHAT IS SUSTAINABLE INVESTING

You may have heard various terms used to describe sustainable investing—socially responsible investing, ethical investing, impact investing, among others. Although each of these terms is relevant to specific financial industry actors, types of clients, investment strategies, or subsectors of activity, they fundamentally describe the same thing:

Investments made with the intention of generating a positive environmental, social, and governance (ESG) impact alongside a financial return.

Investors commonly use sustainable investing to pursue two overarching goals:

- To protect and enhance long-term financial value through addressing ESG risks or investing in solutions to solve environmental and social challenges.
- To protect, enhance, or otherwise positively impact the long-term health of the environment or society through expressing ESG values.

Some examples of ESG issues that may be considered in an investment strategy:

> Environmental: Greenhouse gas emissions, energy management, and water and wastewater management.
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> Social: Access and affordability, labor relations, and diversity and inclusion.
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> Governance: Compensation and benefits, data security, and supply chain management.

WHY SUSTAINABLE INVESTING?

Investors generally pursue sustainable investing strategies for two reasons:

- **Fortify long-term performance.** ESG issues can have a material impact on investment returns. When poorly managed, they can introduce risk into investments; when well-managed, they can produce financial benefits. Some investors consider ESG issues in their investment decision-making to enhance long-term risk-adjusted returns. Others see financial return-generating opportunity in investing in companies that produce solutions to environmental or social challenges.

- **Express personal values.** Some investors desire to help build a world based on positive ESG values—a sustainable world—and adopt investment strategies that align with those values.

SUSTAINABLE INVESTING IMPLEMENTATION STRATEGIES

Investors typically reach these goals using any combination of three strategies:

- **Aligning.** Aligning their values with their investments to minimize exposure to companies or industries whose business practices conflict with their personal convictions.

- **Integrating.** Integrating ESG factors into investment decisions to identify and emphasize investments in companies or industries with positive ESG practices or that solve specific ESG challenges; and to limit exposure to those with poor ESG performance.

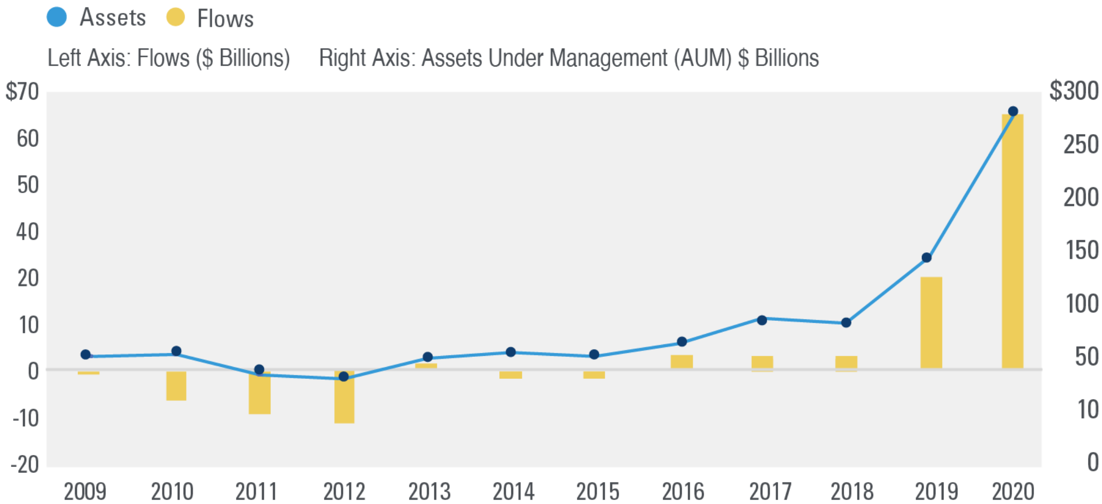
- **Engaging.** Engaging with portfolio companies and fund managers to encourage improvements in ESG performance and mitigate risks related to ESG, and to improve financial systems.

STRONG GROWTH OF US SUSTAINABLE FUNDS

As shown in Figure 1, sustainable investing mutual funds and exchange-traded funds (ETFs) continue to attract record flows from investors. ESG considerations are central to the investment process for these strategies and this commitment is indicated in the “principal investment strategies” section of their prospectus. As of December 31, 2020, assets grew 69% from the year before to $256 billion through the 381 distinct options available (compared to 140 options in 2009).

1 **IMPRESSIVE GROWTH IN SUSTAINABLE INVESTING FUNDS**

Sustainable Assets and Flows (Mutual Funds and ETFs)



Source: LPL Research, Morningstar 12/31/20
Includes open-end and exchange-traded funds available to U.S. investors with intentional sustainable investing mandates. Excludes fund of funds to prevent double counting.

SOLID INVESTMENT PERFORMANCE OF US SUSTAINABLE FUNDS

Sustainable investing funds mostly outperformed in 2020, particularly equity funds. As shown in Figure 2, roughly two-thirds of all sustainable investing funds outperformed their peers (finishing in the top 2 quartiles), with only 12% in the bottom quartile.

2 **SUSTAINABLE FUNDS ENJOYED STRONG PERFORMANCE IN 2020**

Percentile rankings are based on 2020 fund performance relative to broad Morningstar categories

	All Sustainable Funds		Sustainable Equity Funds		Sustainable Fixed Income/Allocation Funds	
Quartile	Number	Percent of Total	Number	Percent of Total	Number	Percent of Total
Top	86	35%	66	40%	20	25%
Second	72	30%	47	29%	25	31%
Third	56	23%	36	22%	20	25%
Bottom	29	12%	14	9%	15	19%
Total	243	100%	163	100%	80	100%

Source: LPL Research, Morningstar 12/31/20

SUSTAINABILITY PERFORMANCE OF US SUSTAINABLE FUNDS

In addition to assessing the investment performance of sustainable funds, it is also important to assess the sustainability performance of these funds to evaluate whether they are doing what they claim to be doing.

Morningstar’s Sustainability Rating, which is based on rolling up Sustainalytics’ company-level ESG Ratings, can be used as a proxy to identify funds that consider ESG factors. About three quarters of sustainable funds received the highest ratings, as compared with only one third of funds overall, illustrating significantly lower levels of ESG risk in their portfolios.

Another important, although often overlooked aspect of sustainable investing is how a fund engages with companies it owns through means including proxy voting in order to provide impact beyond financial return. Often called active ownership or stewardship, shareholder resolutions on proxy ballots often address sustainability issues. Data from 2020 illustrated a mixed bag, with most sustainable funds voting in support of key ESG issues, with large passive funds opposing most of the key votes.

CONCLUSION

Investor interest in sustainable investing has grown significantly over the last couple of years and we don’t expect that momentum to slow any time soon. Strong performance from sustainable funds in 2020 certainly played a role, but we think investors’ increased willingness to express their values through their investments may be a bigger part of the story, which is why we think the growth is—dare we say—sustainable.

IMPORTANT DISCLOSURES

This material is for general information only and is not intended to provide specific advice or recommendations for any individual. There is no assurance that the views or strategies discussed are suitable for all investors or will yield positive outcomes. Investing involves risks including possible loss of principal. Any economic forecasts set forth may not develop as predicted and are subject to change.

References to markets, asset classes, and sectors are generally regarding the corresponding market index. Indexes are unmanaged statistical composites and cannot be invested into directly. Index performance is not indicative of the performance of any investment and do not reflect fees, expenses, or sales charges. All performance referenced is historical and is no guarantee of future results.

Any company names noted herein are for educational purposes only and not an indication of trading intent or a solicitation of their products or services. LPL Financial doesn't provide research on individual equities.

Sustainable investing is subject to numerous risks, chief amongst them that returns may be lower than if the financial professional made decisions based only on investment considerations.

All information is believed to be from reliable sources; however, LPL Financial makes no representation as to its completeness or accuracy.

US Treasuries may be considered "safe haven" investments but do carry some degree of risk including interest rate, credit, and market risk. Bonds are subject to market and interest rate risk if sold prior to maturity. Bond values will decline as interest rates rise and bonds are subject to availability and change in price.

The Standard & Poor's 500 Index (S&P500) is a capitalization-weighted index of 500 stocks designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries.

The PE ratio (price-to-earnings ratio) is a measure of the price paid for a share relative to the annual net income or profit earned by the firm per share. It is a financial ratio used for valuation: a higher PE ratio means that investors are paying more for each unit of net income, so the stock is more expensive compared to one with lower PE ratio.

Earnings per share (EPS) is the portion of a company's profit allocated to each outstanding share of common stock. EPS serves as an indicator of a company's profitability. Earnings per share is generally considered to be the single most important variable in determining a share's price. It is also a major component used to calculate the price-to-earnings valuation ratio.

All index data from FactSet.

Please read the full Outlook 2021: Powering Forward publication for additional description and disclosure.