

The What?, Why?, and How? of ESG

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2023

The What, Why, and How of ESG Integration

- What is ESG?
- What are the key issues and risks?
- How has the pandemic impacted ESG risk analysis?
- Why ESG has become so political and controversial?
- What is the market for ESG-oriented strategies and sustainable funds?
- Why should companies and investors care about ESG principles?
- What are the key ESG approaches and strategies?

What is ESG?

- ESG stands for Environmental, Social, and Governance
- It is a rapidly growing field of investment research and analysis that is complementary to traditional fundamental corporate and financial analysis
- ESG factors are non-financial in nature but can have material financial impacts
- ESG issues tend to be long-term or long-cycle in nature and are compatible with our long-term investment philosophy
- ESG should not be political
- ESG is about research and not ratings
- Investors need to understand if ESG is an investment input or a targeted outcome of a financial product
- ESG can be synonymous with sustainability but does not have to be. Every investment should be analyzed on ESG factors but not every investment will be sustainable as a result
- The growing investor focus on managing ESG risks at the corporate level should yield positive results for our economy and for our society
- A more sustainable economy can have clear benefits for a cleaner environment, safer workplaces, greater equality and opportunity, and less corruption among other long-term benefits

What are the Key ESG Issues, Risks and Opportunities?

- Examples of **Environmental** issues/risks/opportunities
 - ▶ Climate change
 - ▶ Carbon emissions
 - ▶ Waste and water
 - ▶ Opportunities in renewable energy and clean technologies
- Examples of **Social** issues/risks/opportunities
 - ▶ Human capital management
 - ▶ Health and safety
 - ▶ Data privacy and cybersecurity
 - ▶ Labor relations
 - ▶ Supply chain management
 - ▶ Innovation and access to things like financial services, health care, and communications
- Examples of **Governance** issues
 - ▶ Board and management composition and diversity
 - ▶ Executive compensation
 - ▶ Business ethics, anti-corruption, anti-competitive behavior
 - ▶ Overall risk management

Evolving Risks Require Evolving Risk Analysis

- According to the *World Risk Report (World Economic Forum)*, in 2008 only one environmental or societal risk was listed in the top five global risks in terms of impact-pandemics
- By 2018, four out of the top five risks were societal or environmental—extreme weather events, natural disasters, failure or climate-change mitigation & adaptation, and water crises
- In the most recent report, nearly all of the top risks by both likelihood and impact, except for the risks posed by “Goeconomic confrontation”, are ESG-related risks

Risk Categories	Economic		Environmental	Geopolitical	Societal		Technological
	2008	2010	2015	2018	2021	2022	2023
Top 5 Global Risks in Terms of Likelihood	Blow up in asset prices	Asset price collapse	Interstate conflict	Extreme weather	Extreme weather	Extreme weather	Cost-of-living crisis
	Middle East Instability	China economic slowdown	Extreme weather	Natural disasters	Climate action failure	Livelihood crisis	Natural disasters and extreme weather
	Failed and failing states	Chronic disease	Failure of national governance	Cyberattacks	Human environmental damage	Climate action failure	Goeconomic confrontation
	Oil Price Shock	Fiscal crises	State collapse or crisis	Data fraud or theft	Infectious diseases	Social cohesion failure	Climate action failure
	Chronic diseases	Global governance gaps	Unemployment	Climate action failure	Bio-diversity loss	Infectious diseases	Social cohesion failure
Top 5 Global Risks in Terms of Impact	2008	2010	2015	2018	2021	2022	2023
	Blow up in asset prices	Asset price collapse	Water crises	Weapons of mass destruction	Infectious diseases	Climate action failure	Climate action failure
	Deglobalization (developed)	Deglobalization (developed)	Infectious diseases	Extreme weather	Climate action failure	Extreme weather	Climate adaptation failure
	China hard landing	Oil price spikes	Weapons of mass destruction	Natural disasters	Weapons of mass destruction	Biodiversity loss	Natural disasters and extreme weather
	Oil price shock	Chronic disease	Interstate conflict	Climate action failure	Biodiversity loss	Social Cohesion Failure	Biodiversity loss and ecosystem collapse
	Pandemics	Fiscal crises	Climate action failure	Water crises	Natural resources crises	Livelihood Crisis	Large-scale involuntary migration

Source: “The Global Risks Report 2023”, 18th Edition, World Economic Forum

How Has the Pandemic Impacted ESG Awareness?

- COVID-19 raised the profile of ESG, driving inflows into sustainable funds
- Certain social issues gained more attention and investor focus on the following issues has not waned:
 - ▶ Human capital
 - ▶ Cybersecurity and data privacy
 - ▶ Supply chain resiliency
 - ▶ Access to health care and innovation
- Investor focus on governance also appears to be higher post-pandemic, especially related to the following:
 - ▶ Executive compensation
 - ▶ Capital allocation
 - ▶ Risk management processes and procedures
 - ▶ Consideration of sustainability factors at board level
- Post-pandemic backlash now contributing to an anti-ESG movement
- The pandemic and the resulting bear market showed how quickly non-financial risks can become big financial issues
- The post-pandemic recovery favored sustainable investments, but the ground shifted in 2022
- Global attention to climate change has accelerated post-pandemic, but might be more related to war in Europe and policy changes under President Biden and in the EU

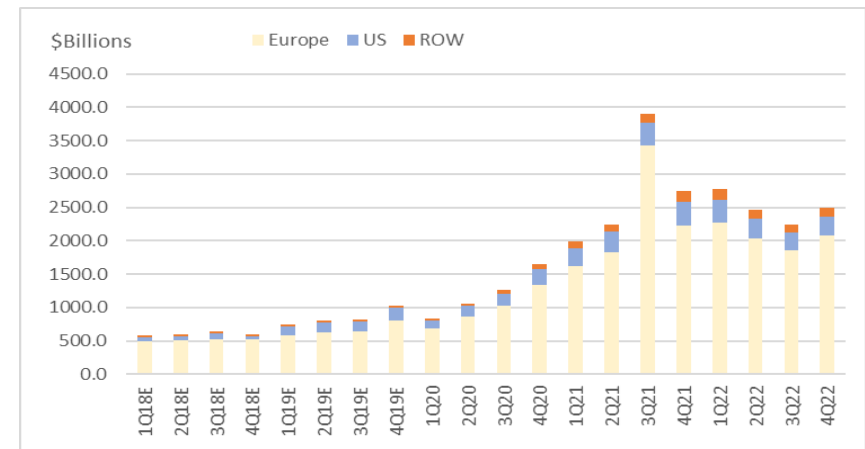
Why ESG Has Become So Political and Controversial?

- ESG has become a business/investment flashpoint for the conflict between the right and left politically in U.S.
- Poor performance of ESG strategies in 2022 and an increasingly politicized environment have opened the door for greater criticism of ESG
- Extremists on both sides are seeking to exploit ESG for political gains
 - ▶ Some ESG proponents more focused on using ESG to drive policy through corporate behavior without regard to returns
 - ▶ Some ESG opponents see companies and investors as too focused on social and environmental issues and not focused enough on profits and returns
- There are intellectual flaws in the arguments at both ends of the spectrum. Appropriate consideration of ESG factors in investment analysis is sensible in identifying both risks and opportunities
- Do we believe companies can be successful long term if they exhibit the following behaviors:
 - ▶ Disregard for the environment and the risks that a changing climate may have on operations or assets?
 - ▶ Disregard for labor or human capital?
 - ▶ Poor governance structures that lack sufficient oversight of executives, operations, and risk?
 - ▶ Lack strategic insight to understand and capitalize on shifting global investment priorities?
- The easy answer to these questions is NO

What is the Investment Market for ESG?

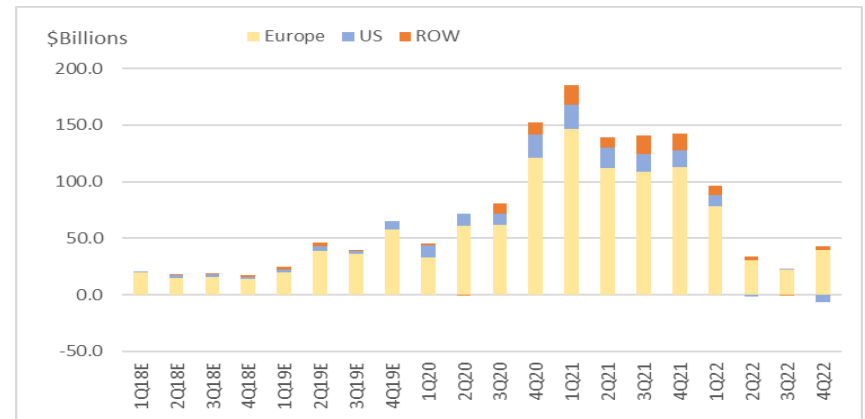
- By any measure, estimated ESG AUM grew rapidly through the pandemic, but has slowed more recently
- Global sustainable assets fell 9% in 2022
 - ▶ Sustainable AUM more stable than overall market
 - ▶ U.S. sustainable AUM declined the most
- Flows into ESG strategies accelerated through 2021 but slowed in 2022
 - ▶ Flows impacted by ESG underperformance and fund reclassifications
 - ▶ ESG fund flows fared better than non-ESG flows
- Studies have shown a positive link between a Fund's *sustainability rating* and fund flows
- Drivers of long-term demand for ESG or sustainable investing appear to be intact
- Millennial investors stand to be the beneficiaries of \$60 trillion in wealth transferred

Quarterly Global Sustainable Fund Assets



Source: Morningstar Direct. Baron estimates prior to 2020.

Quarterly Global Sustainable Fund Flows



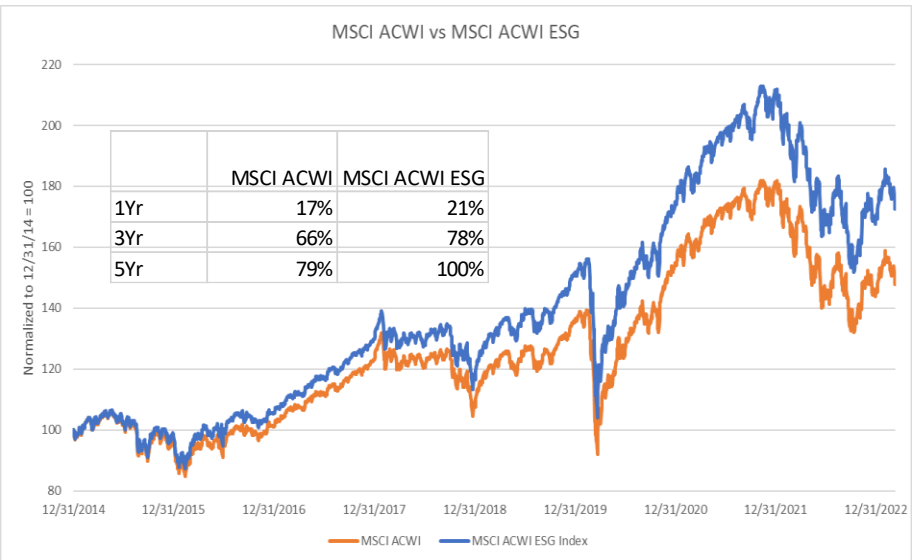
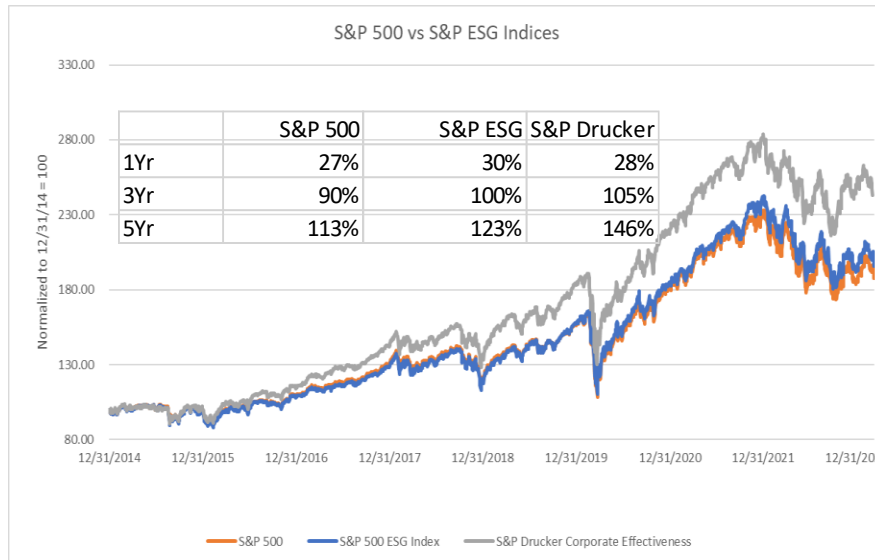
Source: Morningstar Direct. Data as of 12/2022.

The Why? The Investment Case for Integrating ESG

- Studies show that proper evaluation and management of ESG issues at the corporate level can:
 - ▶ Improve growth in revenue and profits over the long term
 - ▶ Lower costs and reduce operational and financial risk
 - ▶ Impact long-term profit margins and returns on assets, equity, and capital
 - ▶ Lower the long-term cost of capital
 - ▶ Lead to sustainable competitive advantages and superior long-term growth
- Studies also show that investors focused on analyzing and incorporating material ESG risks and opportunities into stock selection can:
 - ▶ Generate higher investment returns
 - ▶ Add alpha and lower beta
 - ▶ Potentially reduce risk of catastrophic losses (e.g., bankruptcy)
- ESG analysis is a perfect complement to active management and long-term investing
 - ▶ Allows investors to influence corporate behavior
 - ▶ Companies benefit from improvements in sustainable business practices
- Increasing adoption of ESG by investors can create virtuous and vicious cycles by rewarding companies judged to be well positioned or performing well on ESG issues and punishing those that are poorly positioned or performing poorly

Do Investors Have to Sacrifice Performance?

- This is often the key question and the most debated. However, recent data is clearly tilting in favor of ESG and companies that have good sustainability practices
- Historical studies on ESG performance and alpha generation were mixed. Recent data is more supportive that strong ESG performance is linked to positive alpha
- Broad based ESG indexes have generally performed in-line with benchmarks or better, especially over longer periods.
- The performance of ESG strategies needs to be as good as non-ESG strategies to attract capital; if they are better, they will grow faster



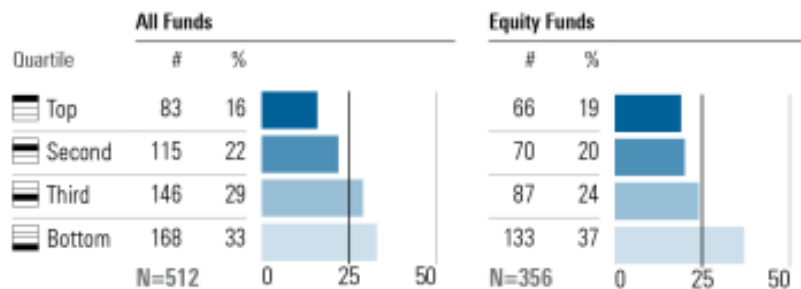
Sources: Bloomberg, S&P Global, and MSCI.

Note: 1-, 3-, and 5-year figures are simple price change figures over those periods as of 3/10/2023 and not annualized returns or adjusted for dividends.

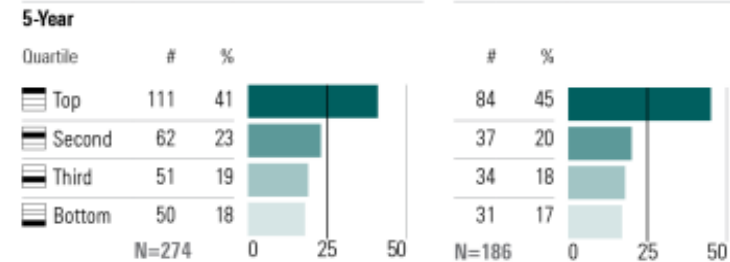
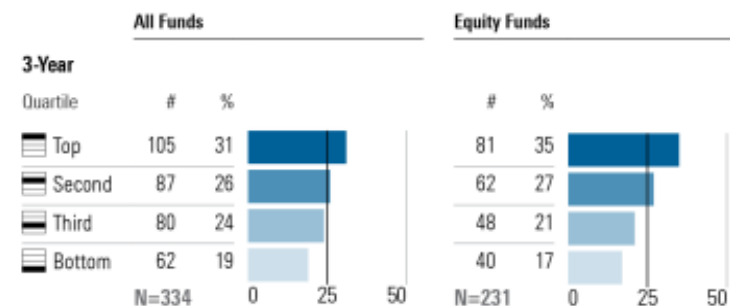
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What About ESG Fund Performance Recently?

- Morningstar data indicates that 38% of Sustainable funds ranked in the top two quartiles in 2022, but 57% and 64% ranked in the top 2 quartiles for the trailing three, and five-year periods, respectively
- Sustainable equity funds fared slightly better than all sustainable funds over each period
- BlackRock, MSCI, and S&P Global have also published research showing that ESG-oriented products have outperformed in recent years and particularly during the recent bear market

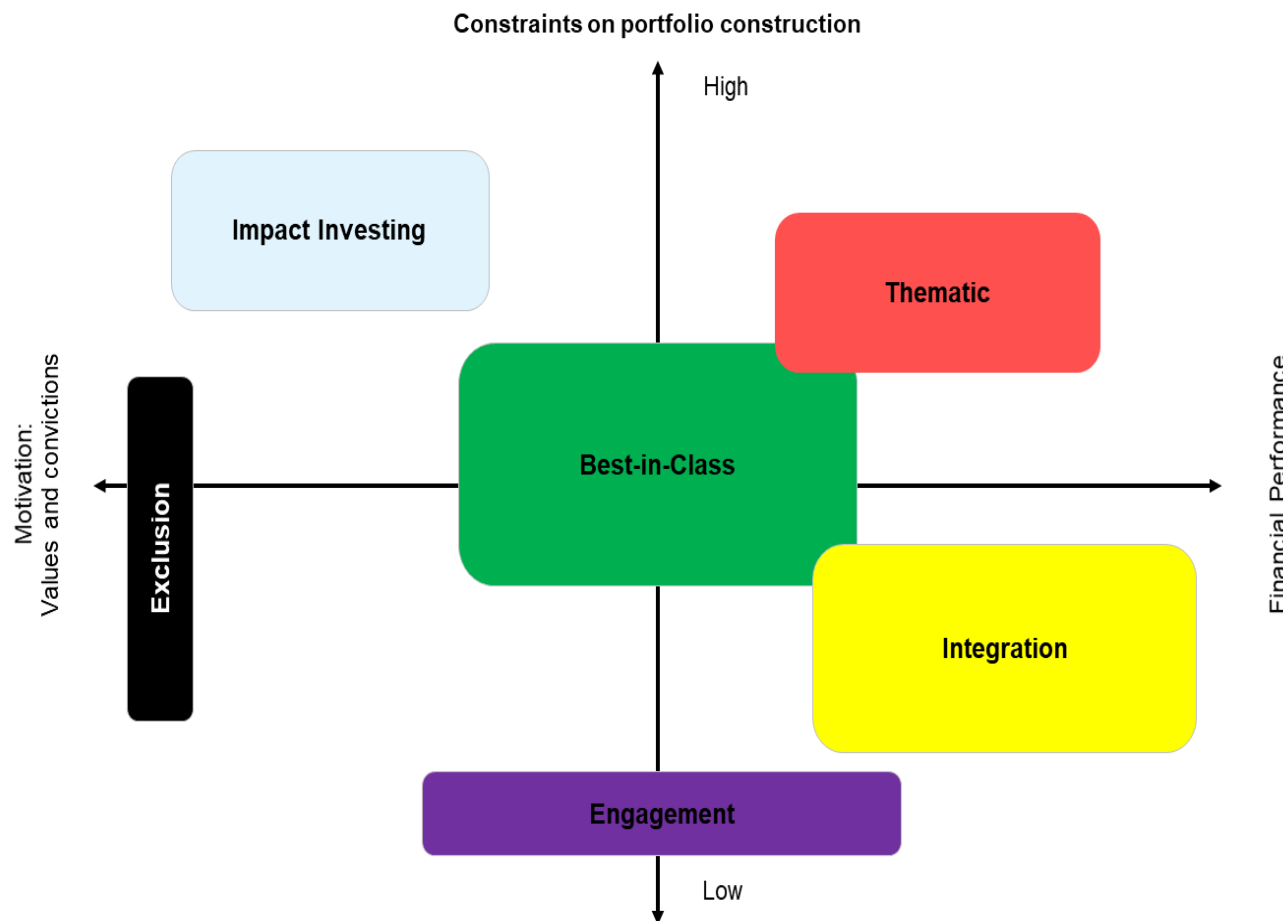


Source: Morningstar Direct. Data as of Dec. 31, 2022.



Source: Morningstar Direct. Data as of Dec. 31, 2022.

What are the Key ESG Strategies?



■ Best-In-Class

- ▶ Only invest in companies with excellent ESG performance relative to peers

■ Thematic

- ▶ Investment focused on opportunities related to a single theme or megatrend

■ Impact Investing

- ▶ Investing in activities with a positive impact on the environment or society

■ Exclusion

- ▶ Filtering out undesirable companies or sectors

■ Engagement

- ▶ Investors aim to influence company management to improve business practices

■ Integration

- ▶ Includes ESG as a fully integrated element of the investment process to support investment decision making

What Does Our Process Look Like?

Baron Fundamental Research

Deep industry
knowledge

Extensive
interaction with
management,
competitors,
suppliers

Consideration of
ESG related risks
and
opportunities

Detailed financial
modeling

Valuation
analysis and
modeling



Investment Decision

What is Baron's Approach to ESG?

- We formalized our approach to ESG in 2019.
 - ▶ Appointed a senior investment professional as our Director of ESG Research
 - ▶ Signed the UN's Principles of Responsible Investment
 - ▶ Created and approved an ESG Investment Policy
 - ▶ Updated our Exclusion Policy and surveillance tools
 - ▶ Introduced tools and data sources to enhance ESG evaluation capabilities
- We see ESG as perfectly aligned with our long-term investment process
 - ▶ Deep bespoke research
 - ▶ Find great growth businesses
 - ▶ Focus on management and governance
 - ▶ Favor sustainable, competitively advantaged businesses
- Training analysts and PMs to focus on material risks and opportunities specific to each company
 - ▶ Teach-ins, speaker series, internal and external research reports
 - ▶ Leverage our relationships and frequent communication with companies to enhance engagement
 - ▶ Incorporate ESG into financial and valuation models where appropriate
- We work to integrate ESG into our investment process, but risk-adjusted returns and fiduciary duty remain paramount

Final Talking Points–ESG is a Journey

- Investors are integrating ESG into their research and investment process because it is both a business imperative and an investment opportunity
- Changing times bring changes in risks and opportunities and necessitate adaptation by investors and businesses
- Risks and opportunities related to ESG can have a significant impact on investment returns and risk
- ESG analysis is a natural extension of an active investor's current approach to fundamental analysis and investing:
 - ▶ Deep fundamental research
 - ▶ Frequent interaction with companies (engagement)
 - ▶ High-quality businesses with durable and sustainably advantaged business models
 - ▶ Long-term approach and long holding periods
- ESG should not be political
- Important to differentiate between including ESG factors as an input or targeting an ESG factor as an outcome
- *ESG scores or ratings* are a challenge but one that will become increasingly manageable
- ESG integration is not a fad and it is not going away. We believe ESG integration is appropriate for the fundamentally driven, active investor

Risks: All investments are subject to risk and may lose value.

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