FUNDAMENTAL EQUITY STRATEGIES

ESG INTEGRATION

GREAT LAKES ADVISORS
A WINTRUST WEALTH MANAGEMENT COMPANY

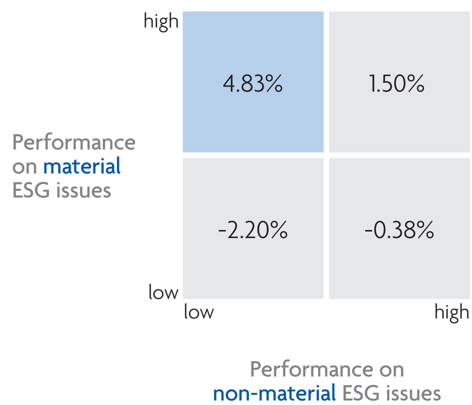
The aim of ESG Integration—integrating environmental, social, and governance information into the investment process—is to make better, more well-informed decisions that will improve investment performance and reduce portfolio risk.

The first step in the process is determining what ESG information is relevant to investment performance. The results of this materiality test will vary across firms and industries. For example, employee health and safety is a more critical issue for coal mining companies than apparel retailers; energy efficiency is more relevant to steel producers than commercial banks. A recent study found that from 1992-2013, companies that perform well *only* on material ESG issues outperformed those that performed well on *all* ESG issues by 333 basis points.

Once the most important ESG issues have been identified, an analysis on the firm's performance over time and compared to peers may provide additional insights that can improve investors' confidence about how well the firm's leaders are managing ESG risks, engaging in cost-saving initiatives, and pursuing related business opportunities. Efforts to reduce material risks, cut expenses, and increase productivity affect the bottom line and will likely be beneficial to shareholders.

Focusing *only* on material ESG issues produces the best returns[1]

Annualized Alpha, 1992-2013



WHY IS ESG INTEGRATION IMPORTANT?

In 1975, 83% of the assets of the S&P 500 were tangible—things like factories, stores, and inventory whose value could be easily captured using conventional accounting metrics. The remaining 17% comprised intangible assets such as brand equity, business methodologies, and logistics systems. In 2015, the opposite was true: 87% of the assets of the S&P 500 were intangible.[2]

Furthermore, non-financial assets such as human, social, and natural capital are not measured in monetary units but nonetheless have financial impacts and can be significant drivers of future firm value. Since conventional accounting practices don't treat these as assets, valuing them, if done at all, is difficult both for investors and company leaders. Indeed, because there are no clear accounting standards for these intangible assets, they are at higher risk of being mismanaged by companies.[3]

Strategically investing in and managing nonfinancial assets is one means for companies to create competitive advantage over other firms. When conducting investment analyses, assessing a firm's performance on material ESG issues over time, similar to comparing annual same store sales figures or changes in cost of goods, can provide strong indicators of how well the company is being managed and positioned for future growth. Comparing these trend data to those of competing firms provides an indication of relative performance and whether a company is increasing its competitive advantage.

Contact
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OUR APPROACH

Assessment: Within the fundamental equity strategies at Great Lakes Advisors (Large Cap Value, Small Cap Core), an ESG scorecard is used to evaluate each portfolio company on approximately 40 ESG issues grouped into five categories: Environmental, Supply Chain, Workforce, Other Social, and Corporate Governance. For each category, the analyst covering the company will determine how relevant those issues are to the company and to the industry and provide a weighting to each category. The analyst will then assess the company's performance on those relevant issues and assign a score between one and five to each category. The result is a materiality-weighted ESG score for each company in our portfolios.

Impact: Part of our investment process is determining what percentage of the portfolio each company should represent. This decision is based upon a number of factors including expected rate of return, the quality of management and the balance sheet, and our confidence based upon how well and how long we have known the company.

A company's ESG score may also affect its portfolio weighting: those companies with a score of four or above will have their weighting increased to reflect our assessment that the company is perceived as less risky or potentially a better value based upon its performance on material ESG factors. Conversely, those companies with a score of two or lower will have their portfolio weighting decreased.

1. Khan, Mozaffar, George Serafeim, and Aaron Yoon. "Corporate Sustainability: First Evidence on Materiality." Accounting Review 91, no. 6 (November 2016)
2. Intangible Asset Market Value Study, Ocean Tomo, 2015
3. SASB FSA Level I Study Guide, Sustainability Accounting Standards Board, 2016.