ESG investing

White paper

ESG investing: Doing well by doing good

Today’s ESG funds help investors stay true to their values and seek their long-term performance goals

Key highlights

- ESG investing has evolved significantly from the early attempts at socially responsible investing (SRI).
- Millennials, women and ultra-high-net-worth investors are driving interest and assets in ESG investing.
- ESG and quality factors overlap but can be used together to identify firms that can do well by doing good.

Summary

Investors have a growing interest in doing good — they want to put their money to work in companies that abide by their personal values. This explains some of the rise in ESG investing — using environmental, social and governance factors to identify opportunities for return.

But ESG investing is about more than doing good — ESG investors expect performance from these strategies along with alignment with their values. Part of the reason why ESG strategies help investors meet higher expectations for performance is the overlap with quality — companies that are good stewards of their businesses tend to be good stewards of investor capital as well.

93% of ESG investors believe they don’t need to sacrifice returns in order to invest according to their values.

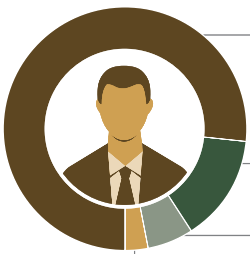
Source: “Return on values, Volume 2,” UBS Investor Watch (2018).

The popularity of ESG investing is expected to increase in the future as high-net-worth, women and millennial investors seek out these strategies. In this white paper, we’ll explore the details about ESG investing and discuss current opportunities in this growing segment of the financial marketplace.

The ABCs of ESG

ESG stands for environmental, social and governance — three factors investment managers can use beyond quantitative financial factors (e.g., earnings growth, return on equity, book value, etc.) to identify opportunities for investment return.

Three-quarters of financial advisors select ESG strategies for clients based on moral or social considerations.



Source: Merrill Lynch Global Wealth Management Enterprise Market Research & Insights team, BofAML U.S. Equity & U.S. Quant Strategy, September 2018

Environmental

- Climate sustainability
- Procurement and use of natural resources
- Energy-efficient procedures
- Efforts to control pollution, waste and carbon emissions

Social

- Equal opportunity policies
- Workforce diversity and inclusion
- Safety and security in the workplace
- Human rights and community involvement

Governance

- Independence and diversity of board members
- Management compensation
- Shareholder rights
- Data privacy and security procedures

Value-driven motivations are noble and worthwhile on their own. But ESG investing takes these goals one step further by seeking opportunities for growth.

Interest in ESG investing has grown primarily out of investor motivations for "doing good"; people want to put their money to work in companies that reflect their own personal values. As an example, an investor concerned about climate change may wish to invest in companies that are committed to reducing carbon emissions and conserving natural resources. Likewise, an investor who values human rights may favor companies that promote diversity and inclusion in their workforces.

These value-driven motivations are noble and worthwhile on their own. But ESG investing takes these goals one step further by seeking opportunities for growth from companies that approach these factors proactively in order to gain a competitive advantage.

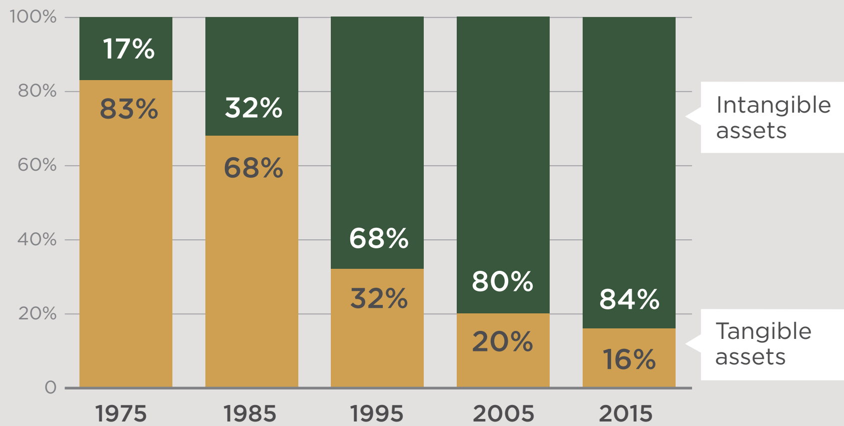
It follows from the belief that companies that do good can also do well — firms that are good stewards of their businesses, from how well they manage their operations and finances to how well they build relationships with customers and the community, also tend to be good stewards of investor capital.

ESG investing seeks to identify factors that define good stewardship across three broad categories. ESG factors are qualitative measures of company performance and subject to interpretation; any investment manager following an ESG approach may read these factors in different ways, so ESG strategies can vary considerably among different funds and strategies.

When considering ESG strategies, investors should seek to get a full understanding of how a particular ESG strategy may complement their personal values as well as fulfill their investment goals.

ESG: yesterday and today

Components of S&P 500 market value



Source: Ocean Tomo, January 2015

Intangible assets include:

- Company brands and trademarks
- Intellectual property
- Research and development
- Human capital
- Culture and reputation
- Risk management

Tangible assets include:

- Equipment and machinery
- Factories, warehouses and office space
- Raw material inventories
- Finished goods
- Financial holdings

The idea of investing with a focus on values has evolved since the 1970s, when the first portfolios and mutual funds designed around socially responsible investing (SRI) were introduced to the financial marketplace.

SRI strategies are distinct from ESG investing in a significant way; stock selection in SRI funds worked as a negative screen, focusing on avoiding stocks that failed to meet predetermined criteria (e.g., excluding “sin” stocks such as alcohol, tobacco, gambling and energy from portfolios). The resulting portfolios often suffered from a lack of proper diversification, and therefore poor investment performance.

Over time, investors began to raise their expectations for thematic or values-based investing — these strategies should invest in a manner that aligns with their values, but they shouldn’t sacrifice performance. These early SRI funds evolved into the current ESG marketplace, a broad landscape of strategies that encompasses positive integration and impact investing. ESG managers were able to meet investors’ new expectations for performance by focusing on intangible assets.

What are a business’s assets? Most investors picture tangible assets that have a defined monetary value — revenues, earnings, shareholder equity and other physical assets found on a company’s balance sheets and 10-k filings. The value of tangible business assets is quantifiable and relatively easy to analyze and compare.

However, a business also holds intangible assets, which can be more predictive of future financial performance, but also require more qualitative analysis and a greater degree of insight. Perhaps more important, there has been a significant shift over the last 40 years in the value of company intangible assets. According to one measure, the value of intangible assets among S&P 500 firms is now worth over four times as much as the value of their tangible assets (see chart above). In the 1970s, this composition was reversed; tangible assets comprised over 80% of a firm’s market value while the value of intangible assets totaled less than 20%.

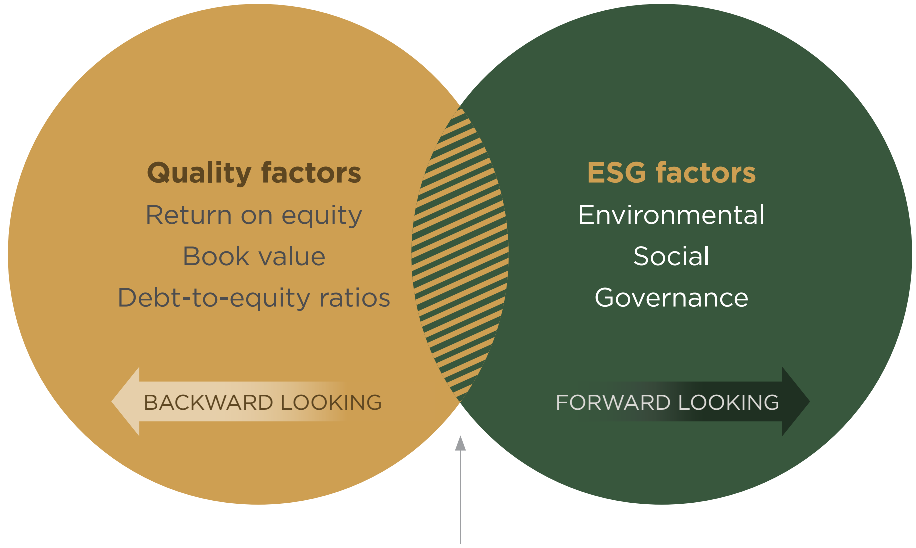
ESG managers can use intangible assets as a way to analyze what actions a company is taking today in order to determine the effect on the business’s future bottom line.

This shift has occurred simultaneously with the evolution of ESG investing. ESG managers can use intangible assets as a way to analyze what actions a company is taking today in order to determine the effect on the business’s future bottom line.

For an investment manager, the implications of this shift mean they now need to place a greater amount of trust in the management of the companies in which they are investing. Trust is more closely linked to qualitative factors of company performance, such as management effectiveness, intellectual capital, workforce engagement and community responsibility.

ESG managers seek to analyze the value of these qualitative factors in order to form an opinion about the future prospects of a company. This focus has helped ESG managers meet performance expectations while continuing to align investor values with their overall financial goals.

Where ESG and quality come together



How ESG and quality factors overlap

Reducing pollution and waste, an environmental factor, can also help a firm control costs and avoid fines and protracted litigation.

Committing to workplace and product safety, a social factor, can help a firm enhance their brand value, which can lead to increased sales.

Promoting leadership diversity, a governance factor, can help a firm develop better internal ideas and more effective management strategies.

Is it reasonable for ESG investors to meet their performance goals while they align their investments with their personal values? We believe it is, because ESG factors by and large overlap with quality factors. These factors not only help companies "do good" in the broader economy and community, they also help investors and the firms themselves "do well" by contributing positively to the firms' bottom lines.

The overlap of ESG and quality factors is more about the outcome of companies doing business the right way. When businesses are managed and run well as a result of adhering to ESG standards, they tend to experience less variability in their performance. Management teams that are experienced and transparent generally take on less risk. Similarly, they are less likely to become insolvent or file for bankruptcy.

For investors, ESG strategies bear many similarities to quality strategies — both offer less likelihood of earnings volatility and greater opportunity for downside protection. These traits tend to emerge in the late stages of the economic cycle; well-managed companies are often in strong financial positions and have different levers they can use to adapt to changes during recessionary cycles.

While these two factor-based strategies share many characteristics, there are also some important differences that make ESG and quality factors complementary strategies. For example, quality factors tend to be more finance-oriented and quantitative. They also tend to be backward-looking, reflecting the results that a firm has already achieved.

On the other hand, ESG investing relies heavily on qualitative nonfinancial factors, which can be more illustrative of future performance by shedding light on how effective a firm's management team is in running the business.

Common characteristics of ESG companies and stocks:

- Lower incidence of bankruptcy
- Less likely to experience large price declines
- Fewer earnings declines and lower EPS volatility
- More likely to outperform their peer group for three-year returns

Source: Nationwide Investment Research, January 2019

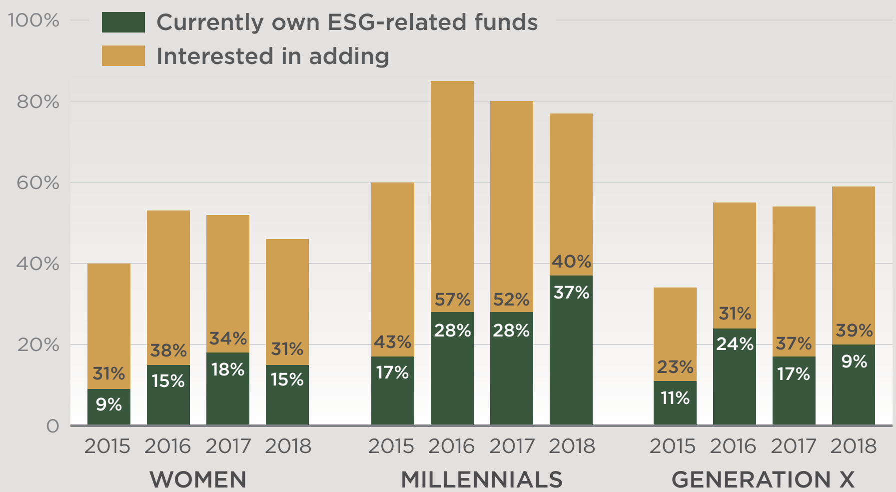
Demographics drive ESG interest

Investor interest in ESG and sustainable investing has risen as ESG managers have been better able to meet performance expectations. That has meant more assets have flowed into ESG strategies.

But changing demographics are also providing a strong tailwind to this market. Interest in ESG tends to be higher among certain demographic groups: ultra-high-net-worth individuals, women, and younger generations, such as Generation X and millennials.

Changing attitudes about ESG investing may be most significant across generations, especially as the number of millennials in the investor population increases rapidly in the coming years.

Growing interest in ESG-related funds



Source: 2018 U.S. Trust Wealth and Worth Survey

Assets in ESG strategies exceeded **$70.0 billion** in 2017.

ESG was the **fastest growing** smart beta strategy between 2012 and 2017.

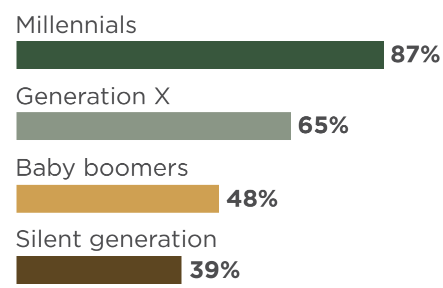
Source: Strategic Insight SimFund, BofA Merrill Lynch U.S. Equity & U.S. Quant Strategy

Millennials

Younger investors demonstrate higher interest in ESG strategies than other generations, and they are also driving the increase in ownership of ESG-related funds. Millennial interest in ESG investing is important in light of the upcoming wealth transfer opportunity among generations. Millennials (and to some extent Generation X as well) are said to be on the receiving end of the largest-ever transfer of financial wealth, as assets from the boomer and silent generations are passed down to their younger beneficiaries.

ESG is important to investment decision making

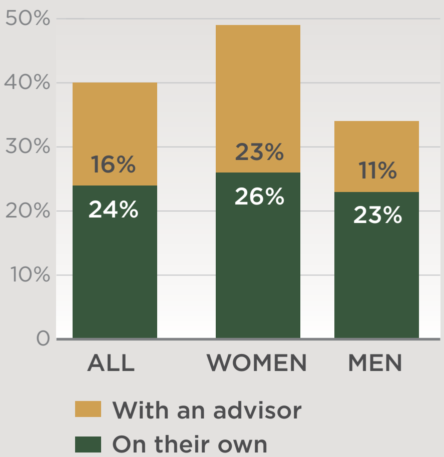
(percentage who agree)



Source: U.S. Trust/Bank of America Private Wealth Management, 2018 U.S. Trust Insights on Wealth and Worth

If the shift in interest toward ESG investing remains strong, it's likely that millennial investors will look to invest a large portion of this wealth transfer in ESG strategies. If their parents' financial advisors don't offer access to ESG strategies, these younger investors are likely to seek out advisors who will.

Who reviews their portfolio for ESG impact?



Source: U.S. Trust/Bank of America Private Wealth Management, 2018 U.S. Trust Insights on Wealth and Worth

Women outpace men 64% to 46% in valuing the importance of ESG in their investment decisions.

64% | 46%

Women

Women outpace men 64% to 46% in valuing the importance of ESG in their investment decisions, according to a 2018 U.S. Trust Wealth and Worth survey. Women are also more likely to believe that a company has responsibilities for the environment and society, in addition to making profits.

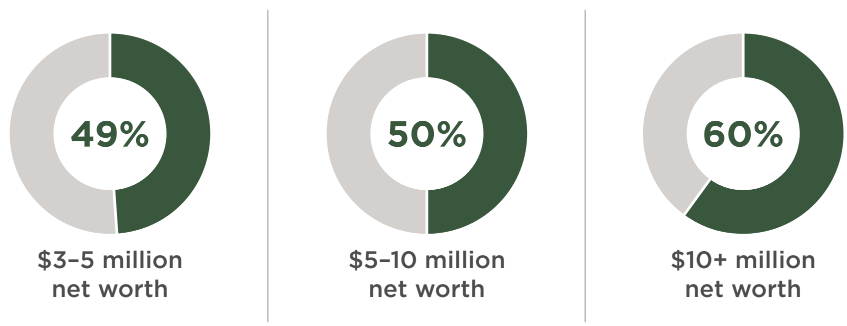
Women are more likely than men to be open to considering ESG strategies. More women than men currently own ESG investments (15% to 10%). And about half of women currently review their investment portfolios for ESG impact, some with a financial advisor, but more do so on their own. Only around one-third of men do the same.

Ultra-high-net-worth investors

Interest and acceptance of ESG strategies is strongly correlated with wealth. But even among those in the high-net-worth category (at least $3 million in assets), ultra-high net worth individuals (above $10 million in assets) may be more receptive to considering ESG investments for their portfolios.

Ultra-high-net-worth acceptance of ESG also presents an interesting opportunity related to generational wealth transfer. Many high-net-worth investors are planning to transfer a significant portion of their assets to children and other beneficiaries in younger generations. The shared interest in ESG investing between ultra-high-net-worth and millennial investors is a connection point advisors can use to build long-lasting client relationships and ensure the consistent management of family wealth.

ESG importance among high-net-worth investors



Source: U.S. Trust/Bank of America Private Wealth Management, 2018 U.S. Trust Insights on Wealth and Worth

Putting ESG to work: a double-filter approach

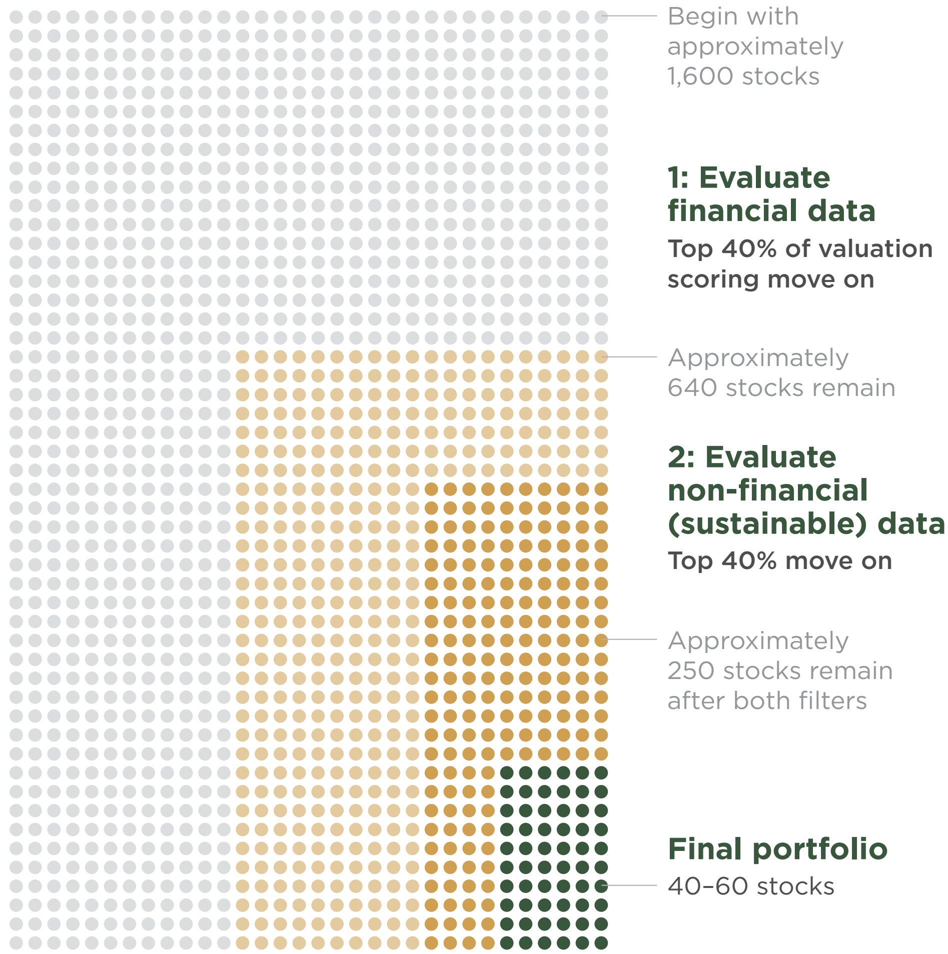
The similarities between ESG and quality investing offer investors and investment managers a good framework for implementing ESG principles in funds and portfolios.

For a real-world example of putting ESG to work, let's consider the strategy behind the Nationwide Global Sustainable Equity Fund, which is subadvised by UBS Asset Management. The fund managers apply their ESG approach independently of their quantitative analysis of financial data, so the two strategies are more complements of each other rather than ESG being a "crutch" for the quality approach.

The subadviser's ESG approach stands out in the screening process of nonfinancial sustainable company data. Because much of the data on sustainability factors is qualitative in nature, it is often not reported in a standard fashion. Many managers who are integrating ESG factors for the first time rely on third-party databases that use a quantitative approach to ESG analysis. However, there are no standard reporting requirements for forward-looking ESG data, so it is problematic to analyze companies for ESG compliance by screens alone. Quite often, this data is out of sync with forward-looking assessments; for example, issuing high ratings when a company's ESG policy is deteriorating or maintaining low ratings despite significant sustainability improvements by corporate management.

To counter the shortcomings of external databases, UBS built their own proprietary database of industry-specific ESG statistics going back to 1997. Industry specificity is important because some ESG factors are more relevant than others in certain areas of the economy. As an example, there is a greater emphasis on environmental factors when screening firms in the industrial and materials sectors, but because sectors such as technology and financial are more service-oriented, social factors are considered more significant for them. Governance factors are applied equally across all sectors.

How UBS Asset Management's approach works



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Key takeaways

1

ESG investing differs significantly from earlier socially responsible investing strategies in their positive inclusion approach to stock selection.

2

ESG and quality factors overlap in many ways, which makes ESG strategies better able to meet investors' higher performance expectations.

3

Millennials, women and ultra-high-net-worth investors are poised to drive continued interest in ESG investing in the years ahead.

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is on your side

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MSCI World Index Free Index: An unmanaged, free float-adjusted, market capitalization-weighted index that is designed to measure the performance of large-cap and mid-cap stocks in global developed markets as determined by MSCI. The "Free" suffix denotes an index with a somewhat different history but the same constituents and performance in relation to its counterpart index without the suffix.

S&P 500 Index: An unmanaged, market capitalization-weighted index of 500 stocks of leading large-cap U.S. companies in leading industries; gives a broad look at the U.S. equities market and those companies' stock price performance.

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MFM-3018AO (01/19)