Adding Value Through Large-Cap Sustainable Investing

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Notes from the Global Growth Equity Desk

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"We can measure the impact of ESG integration with an approach reminiscent of the traditional Brinson attribution model."

When portfolio managers incorporate Environmental, Social and Governance (ESG) factors into an investment strategy, they consider those issues in conjunction with traditional financial analysis. When selecting investments, portfolio managers incorporate ESG factors into the portfolio's existing asset class, time horizon, and objectives. Therefore, ESG factors may limit the investment opportunities available, and the portfolio may perform differently than those that do not incorporate ESG factors. Portfolio managers have ultimate discretion in how ESG issues may impact a portfolio's holdings, and depending on their analysis, investment decisions may not be affected by ESG factors.

Doing Well and Doing Good

Can my investments do well while the companies I invest in do good? This is a question many investors ask as they consider portfolios that incorporate environmental, social and governance (ESG) factors in their investment process.

Many studies have attempted to answer this question and their conclusions have been inconsistent. Some of the research relies on comparing ESG strategy performance to a broad universe of non-ESG strategies. Other studies compare the performance of a basket of companies with favorable sustainability characteristics to the overall market.

We think there's a better way to frame the question: Focus on a manager's ESG integration skills by isolating how each pillar of an investment process affects performance over time.

Measuring Sustainable Investing Effectiveness

We can measure the impact of ESG integration with an approach reminiscent of the traditional Brinson attribution model. Among other things, this approach can quantify the benefit of being overweight an outperforming sector or underweight an underperforming sector.

Using a similar technique, we can measure the contribution or detraction of being overweight companies with higher ESG scores[1].

We calculate the ESG score using external data sources (e.g., MSCI, Sustainalytics[2]) to compare companies within each sector and industry based on their management of ESG risks and opportunities. Companies with high ESG scores are viewed as ESG leaders, while those with low scores are considered laggards.

ESG Score

Low → High

Laggard

A company lagging its sector peers based on its high exposure and failure to manage ESG risks.

Leader

A company leading its sector peers in managing material ESG risks and opportunities.

Source: MSCI.

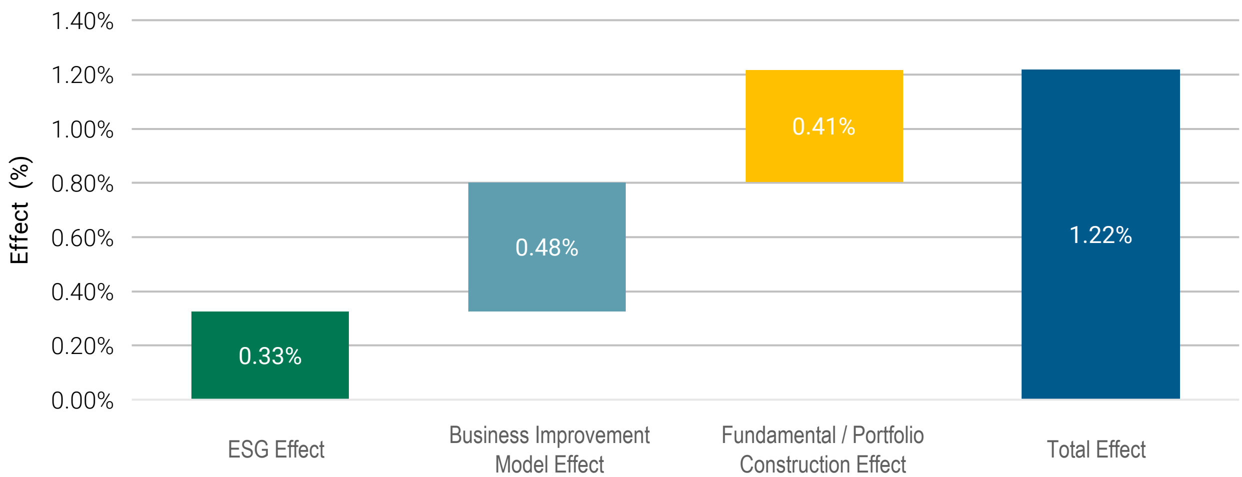
[1] The ESG score is calculated using a combination of data from MSCI and Sustainalytics. It compares a company's risk on various environmental, social and governance factors to its sector peers and assigns a score between 0 (worst) and 100 (best) for each company in the peer group.

[2] Sustainalytics is a firm that produces environmental, social and governance (ESG) research on public companies.

Figure 1 shows attribution results for the U.S. Sustainable Large Cap Core strategy since inception. The analysis illustrates the positive ESG effect on the strategy relative to the S&P 500® Index. The dark green segment represents the allocation effect from an overweight position in companies with above-median ESG scores combined with an underweight in companies with below-median ESG scores. The market rewarded companies with higher scores during this period, which added value to the portfolio.

Figure 1 | Allocating to ESG Leaders Added Value

Performance Attribution: U.S. Sustainable Large Cap Core vs. S&P 500 Index



Data from 6/30/2016 to 12/31/2023. Performance is annualized in USD, gross of fees. Source: FactSet

Past performance is no guarantee of future results.

ESG Doesn't Exist in a Vacuum

ESG risks and opportunities are just one component of the multiple factors we consider in the investment process as **Figure 1** helps demonstrate. The Business Improvement Model Effect measures the impact of investment decisions using our proprietary business improvement score. This score quantifies the financial characteristics of each company our sector specialists consider most important. As shown in **Figure 1**, an overweight position in companies with higher scores coupled with an underweight in stocks with low scores added value.

The Fundamental/Portfolio Construction Effect also contributed to performance and reflects portfolio decisions that can't be explained by the ESG or Business Improvement models. This calculation, reflected in the orange segment, is simply the difference between the total excess return over the index and the sum of the ESG and Business Improvement effects. Portfolio construction is critical to managing an integrated ESG portfolio to help ensure that unintended factor exposures—e.g., market capitalization, momentum, volatility or style biases—don't detract from or overshadow stock-specific decisions.

Done Right, Sustainable Investing Adds Value

This exercise shows that each dimension of the investment process has the potential to add value to relative performance. It's important to note that ESG metrics represent only a portion of the total excess return. We believe a quantitative business improvement model that identifies companies with attractive financial characteristics and the insights of an experienced fundamental investment team are crucial drivers of relative performance.

Returning to the original question: Does ESG investing add value? We believe the answer is yes. The attribution example illustrated in this paper shows that for the large U.S. companies in our portfolio, being an ESG leader based on our scoring methodology was a tailwind to performance. We believe this scenario will continue as investors pay closer attention to the material ESG risks and opportunities companies face relative to their peers.

Performance as of 12/31/2023	1 Year (%)	3 Years (%)	5 Years (%)	Since Inception* (%)
U.S. Sustainable Large Cap Core - Net Return	24.62	9.19	15.89	14.12
U.S. Sustainable Large Cap Core - Gross Return	25.18	9.59	16.37	14.86
S&P 500® Index	26.29	10.00	15.69	--

Data as of 12/31/2023. Performance in USD. Periods greater than one year have been annualized. *Inception date: 7/1/2016. Source: FactSet. Past performance is no guarantee of future results. Investment return and principal value of security investments will fluctuate. The value at the time of redemption may be more or less than the original cost.

Many of American Century's investment strategies incorporate sustainability factors, using environmental, social, and/or governance (ESG) data, into their investment processes in addition to traditional financial analysis. However, when doing so, the portfolio managers may not consider sustainability-related factors with respect to every investment decision and, even when such factors are considered, they may conclude that other attributes of an investment outweigh sustainability factors when making decisions for the portfolio. The incorporation of sustainability factors may limit the investment opportunities available to a portfolio, and the portfolio may or may not outperform those investment strategies that do not incorporate sustainability factors. ESG data used by the portfolio managers often lacks standardization, consistency, and transparency, and for certain companies such data may not be available, complete, or accurate.

Sustainable Investing Definitions

Integrated: *An investment strategy that integrates sustainability-related factors aims to make investment decisions through the analysis of sustainability factors alongside other financial variables in an effort to make more informed investment decisions. A portfolio that incorporates sustainability factors may or may not outperform those investment strategies that do not incorporate sustainability factors. Portfolio managers have ultimate discretion in how sustainability factors may impact a portfolio's holdings, and depending on their analysis, investment decisions may not be affected by sustainability factors.*

Sustainability Focused: *A sustainability-focused investment strategy seeks to invest, under normal market conditions, in securities that meet certain sustainability-related criteria or standards in an effort to promote sustainable characteristics, in addition to seeking superior, long-term, risk-adjusted returns. Alternatively, or in addition to traditional financial analysis, the investment strategy may filter its investment universe by excluding certain securities, industry, or sectors based on sustainability factors and/or business activities that do not meet specific values or norms. A sustainability focus may limit the investment opportunities available to a portfolio. Therefore, the portfolio may underperform or perform differently than other portfolios that do not have a sustainability investment focus. Sustainability-focused investment strategies include but are not limited to exclusionary, positive screening, best-in-class, best-in-progress, thematic, and impact approaches.*

Past performance is no guarantee of future results.

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