HIGHTOWER
GLOBAL INVESTMENT SOLUTIONS

360

2015 Q2

Green – Between Blue and Yellow

It is universally accepted that the color green is associated with nature, spring, and even hope. Still remaining, however, is the global challenge of how *green* is understood and treated as an element of the preservation of nature and natural resources. A child born in the United States today will create 13 times more ecological damage over a lifetime than a child born in Brazil, and the U.S. consumer still has not met the standards of ecologically minded developed nations —regrettably taking a "back-seat" in global rankings.

A child born in the United States today will create 13 times more ecological damage over a lifetime than a child born in Brazil.

The recent decline in the price of energy, especially oil, will likely not help to expedite agreeable change. It is not only conceivable that the current (much "greener") shale-gas boom may lose its appeal, but so could commitments made to the alternative energy sector in areas such as solar and wind power; very favorable long-term developments in energy conservation and alternative forms of power could be at risk. With this in mind, we continue to see encouraging trends related to sustainable and green investing opportunities, potentially allowing for alternative forms of energy consumption to become economically more feasible.

At HighTower, we do not seek value on the basis of one single opinion, as is more common with traditional Wall Street firms, but instead continue to exchange best ideas and carefully select our economic advisors and research partners. For this edition of our GIS 360, our friends Elizabeth Coston, from the Kellogg School of Management, and Alexander Bass, Executive Director here at HighTower, have kindly contributed their best thinking on recent developments in the green investing space.

We continue to see encouraging trends related to sustainable and green investing opportunities.

HighTower's approach to research is genuine, as we do not have to sell product, but rather provide advice to our clients. Our business was created with an objective to reduce or avoid many conflicts we may have faced earlier in our careers as financial advisors. True to our promise, we strive to continue providing "an unobstructed view" to our clients.

We sincerely thank you for your continued trust and support.

MATTHIAS PAUL KUHLMEY
Partner & Managing Director
Head Global Investment Solutions (GIS)

Early Innings for Sustainable Investing

BY ALEXANDER BASS
Executive Director, HSW Advisors at HighTower

Depending on how one defines sustainable investing, we can trace its beginnings to several start dates: the emergence of socially responsible investing (SRI) from the foundations of ethical investing in 1960s, the establishment of the first ethical mutual fund in 1971, or the more recent emphasis on environmental, social, and governance (ESG) analysis promoted since the late 1990s. But despite its existence in various forms for several decades, and "sustainability" being the topic du jour in corporate America, the sustainable investing movement feels very nascent. Individual investors have not embraced SRI on a significant scale, with limited investment choice, "mixed" performance results, and lack of information all cited as causes for inaction.

Some notable shifts are taking place, however, with institutional investors taking the lead. Launched in 2006, the United Nations' Principles for Responsible Investing (PRI) initiative has attracted asset managers and owners as signatories (representing over $45 trillion in assets) who pledged to incorporate sustainability issues into their investment practices.[1] The initiative helped further publicize SRI and coined the term "Responsible Investor," as one who incorporates ESG factors into the investment process. Although abiding by the principles is voluntary, their increased adoption is a reflection that asset owners consider ESG issues to be of importance for their portfolio and advisors view integrating PRIs into their investment process as part of their fiduciary duty to clients. Competitive pressures also play a part, as investment firms seek to differentiate themselves, or simply keep up with the trend.

The challenge to a large degree is in analyzing and quantifying ESG factors and their impact on companies and market performance. To their credit, companies are increasingly measuring and reporting their ESG performance, and there are several financial data providers (including Bloomberg and MSCI) that compile the information—but the data is inconsistent and often incomparable across companies and industries.

Are the companies who accept and disclose their sustainability practices better investments? The answer is an unequivocal "Yes."

The newly established Sustainability Accounting Standards Board (SASB) is looking to solve that challenge, with the development of standardized sustainability accounting standards, defined specifically for each industry, to complement traditional financial accounting standards. The end goal is to have companies report on individual ESG metrics in their regular filings to the SEC. However, the SASB standards will not be finalized until 2016, and we can expect a long runway until they are fully accepted and integrated.

It seems intuitive that focusing on the full spectrum of risks broadly encompassed within "sustainability issues" is prudent when evaluating an investment, but is there any financial basis for doing so? Are the companies who accept and disclose their sustainability practices better investments? The answer is an unequivocal "Yes."

[1] http://www.unpri.org/news/pri-fact-sheet/

When the Carbon Disclosure Project, in conjunction with PricewaterhouseCoopers, evaluated companies in terms of their carbon disclosure practices, those ranking in the top 25% by level of disclosure were shown to have a higher return on equity and more stable cash flows.[2] In another report, Deutsche Bank analyzed over 100 academic studies on sustainable investing from around the world and found a strong correlation between companies with high corporate commitment to social responsibility and ESG practices and reduced cost of capital.[3] The evidence supports the notion that companies with high ESG policy and disclosure ratings are lower fundamental-risk investments—and as the writers of the report correctly point out, these findings should place sustainability measurement and disclosure directly in the sights of every CFO.

With proven financial merits of advanced sustainability policies, along with a greater shift towards responsible investing in general, why are individual investors largely absent from the conversation?

The evidence supports the notion that companies with high ESG policy and disclosure ratings are lower fundamental-risk investments.

The issue lies within the relative lack of investment options, the broad and inconsistent interpretation of what constitutes an SRI strategy by each asset manager, and the fairly run-of-the-mill performance of many of these strategies. Despite the clear benefit to companies in measuring and disclosing ESG factors, many traditional SRI asset managers have not been able to capture this premium, and the largely accurate perception by individual investors is that they are not being rewarded for shifting their portfolios to embrace SRI strategies. In fact, comparing historical performance of SRI and traditional strategies shows that the returns are nearly identical. Proponents of SRI investing take a "glass half full" view and cite this as a positive, proving there is no cost to employing an SRI approach. The other conclusion of evaluating SRI fund performance is that there is much less variability in performance for SRI funds, as many of them look and act the same.

The issue lies within the relative lack of investment options.

Both findings are reasonable and expected, given the early stages for mainstream SRI investing. Most asset management firms start out with a core broad-market investment approach to develop their SRI capabilities, branching out to strategies focusing on different market caps, investment styles, or geographies only when there is enough investor demand. This certainly differs from traditional investment funds, where there is a multitude of different investment styles and portfolios to be found.

The emphasis asset managers place on each of the ESG factors also differs. Some firms invest in what could be classified as a traditional portfolio, while engaging in shareholder activism to petition for greater disclosure or change in one of the ESG practices. As a result, individual investors committed to SRI are required to understand its varying application among the many funds and decide what best aligns with their values.

With sustainable investing gaining momentum, more asset managers will continue to enter the field, leading to greater investment choice and emergence of differentiated and clearly winning strategies. For now, though, we are still in the early innings.

[2] https://www.cdp.net/en-US/News/CDP%20News%20Article%20Pages/SP-500-companies-leading-on-climate-change-action-doubled.aspx
[3] Deutsche Bank Group: Sustainable Investing, Establishing Long-Term Value and Performance, June 2012

Bonds Go Green

BY ELIZABETH COSTON
Manager, Social Innovation and Impact Investing, Kellogg School of Management

At the United Nations Framework Convention on Climate Change in 2009, world governments agreed to cooperate on limiting the increase in global temperatures to 2° Celsius above pre-industrial levels in order to prevent the negative effects of climate change. While an admirable goal, the obvious question was how to achieve it. Indeed, the World Bank's "Strategic Framework for Development and Climate Change" noted that one of the main barriers to addressing climate change is an "enormous financial gap." But just how large is this gap?

The International Energy Agency estimates that the world will need to invest $36 trillion into clean energy projects through 2050, or roughly $1 trillion per year for the next 35 years. While governments will play a large part in making these investments, increasing deployment of private sector capital is essential.

The primary relationship between capital markets and green[4] investments until recently has been to facilitate equity financing. When technologies such as solar panels and wind turbines were in early stages of development, private equity and venture capital (along with government subsidies) were the most accessible sources of capital.

But as these technologies have been tested, proven, and refined, they have become slightly de-risked and therefore more suitable for public equity and debt financing. Leading financial institutions have taken notice of this growing market opportunity.

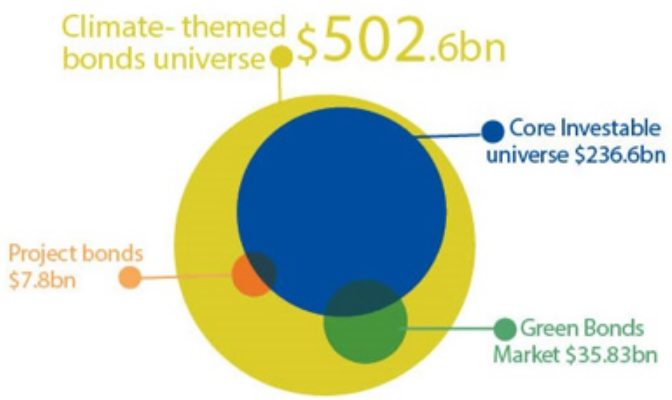
One of the main barriers to addressing climate change is an "enormous financial gap." But just how large is this gap?

Since the mid–late 2000's, a universe of "climate-themed bonds" has emerged. As the name suggests, these are bonds whose proceeds are directed to climate-related projects. In an effort to help both issuers and investors identify potential opportunities, the World Bank established the concept of a "green bond" in 2007. The key defining element of a green bond is how its proceeds are utilized. The funds must be invested into specific sectors, including:

- **Renewable energy**
- **Energy efficiency (including efficient buildings)**
- **Sustainable waste management**
- **Sustainable land use (including sustainable forestry and agriculture)**
- **Biodiversity conservation**
- **Clean transportation**
- **Clean water and/or drinking water**

[4] Climate change mitigation, adaption solutions, energy efficiency, renewable energy etc

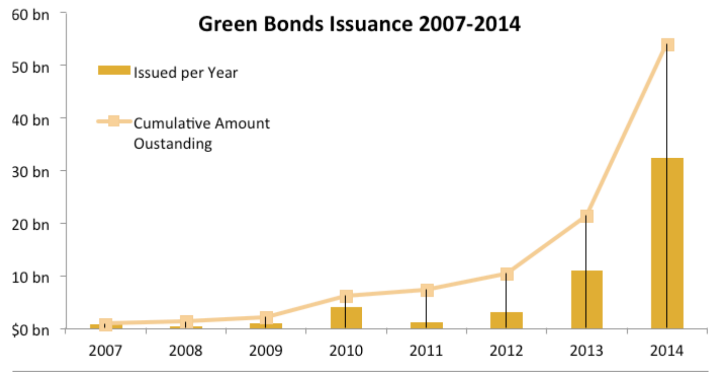
While the overall climate-themed bond universe is estimated to be about 500 billion dollars, the core investable universe (defined as $200-plus billion dollar issuance size and investment grade rating) is about half that size, and green bonds are only a fraction of that core. Part of the reason for this has to do with where and how green bonds have come to market up to this point. From 2007–2013, multilateral development banks (MDBs), such as the International Finance Corporation (IFC) and the European Investment Bank (EIB), were the sole suppliers of green bonds. Offerings were often less than $10 million in size, making them impossibly small for most institutional investors. Typical investors were socially-conscious European pension funds and small impact-investing firms.



Source: Climate Bonds Initiave

In November 2013, the first corporate issuer entered the market, with a $500 million green bond, and since then the market has experienced explosive growth. Along with that growth has come a number of firsts: the first green bond by a consumer-packaged-goods company, the first green bond by a U.S. REIT, and the first green bond index, to name a few. This increased corporate participation meant nearly $40 billion of green bond issuance in 2014.

The larger overall market size, as well as a larger average issue size, has finally opened the door to institutional investors. From



Source: Climate Bonds Initiave

an institutional investor perspective, corporate green bonds offer green exposure without increased risk, since in most cases the bonds carry the same credit profile and pay the same yield as an issuer's conventional bonds.

In November 2013, the first corporate issuer entered the market, with a $500 million green bond, and since then the market has experienced explosive growth.

Retail investors are interested in getting in on the action as well. A member of the World Bank Group announced in March that they were launching a program that is designed to allow individual US investors to buy high investment grade rated bonds and support development in emerging markets. The bonds are not exclusively targeted at green projects, but a recent offering in September was specifically earmarked for renewable energy and energy efficiency projects in developing countries.

There are more innovations on the horizon. Of particular interest to individual investors may be emerging opportunities in the municipal bond market. An important piece of addressing climate change is the development of low-carbon and climate resilient cities. To that end, Massachusetts issued the first green municipal bond in May 2013, with New York State following shortly thereafter. New York Governor Andrew Cuomo also proposed a "green bank" that would facilitate investment in the state's growing clean energy economy by "opening up financing markets and expanding availability of capital." In particular, a green bank could offer credit enhancements, such as loan loss reserves, which would reduce downside risk for investors.

Despite the promise of green bonds, investors should be aware of several risk factors in this nascent space:

With sustainable investing gaining momentum, more asset managers will continue to enter the field, leading to greater investment choice and emergence of differentiated and clearly winning strategies.

Liquidity: Although the average issue size is increasing, many bonds are still relatively small and are held by a concentrated few investors. While, for example, pension funds may be comfortable holding a bond to maturity, if an individual investor wants to sell after a few years, he or she may find that there is limited trading volume for a particular issue.

Sector Allocation: The vast majority of climate-themed bonds have been issued in the transportation sector, with proceeds funding rail projects and electric vehicle manufacturing. In second place is energy, with issuers tapping funding for clean energy generation. A green bond portfolio is likely to overweight exposure to these industries, and therefore investors should consider their green bond holdings within the context of their overall portfolio allocations.

Reporting Standards: Because this is such a young investment theme, reporting standards are being developed as we go. While many issuers are making best attempts at transparency, it is sometimes unclear exactly how proceeds are going to be invested, and what the repercussions are if they are not allocated as planned.

For early adopters, it is important to consider these risk factors when deciding whether and which green bond investments to pursue. However, as green credit products continue to evolve and mature over time, many of these issues should be resolved.

HIGHTOWER
GLOBAL INVESTMENT SOLUTIONS

360

This is not an offer to buy or sell securities. No investment process is free of risk and there is no guarantee that the investment process described herein will be profitable. Past performance is not indicative of current or future performance and is not a guarantee. The investment opportunities referenced herein may not be suitable for all investors.

These materials are solely informational. In preparing these materials, we have relied upon and assumed without independent verification, the accuracy and completeness of all information available from public and internal sources. HighTower shall not in any way be liable for claims and make no expressed or implied representations or warranties as to their accuracy or completeness or for statements or errors contained in or omissions from them. Matthias Paul Kuhlmey is an investment professional registered with HighTower Securities, LLC, member FINRA, MSRB and SIPC & HighTower Advisors, LLC a registered investment advisor with the SEC. All securities are offered through HighTower Securities, LLC and advisory services are offered through HighTower Advisors, LLC