



# Doing Well and Doing Good?

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Growing interest in the impact of fossil fuels on the global climate may spark questions about whether individuals can integrate their values around sustainability with their investment goals and, if so, how. As citizens, individuals can express their political preferences around sustainability through the ballot box. As investors, they also can express their preferences through participation in global capital markets. One key question these investors face is how to do this without compromising their desired investment outcomes. For instance, how can they reduce their portfolio's environmental footprint while maintaining sound investment principles and achieving their investment objectives?

Sustainability preferences are not generally restricted to greenhouse gas emissions. Many investors may also have concerns about land use and biodiversity, toxic spills and releases, operational waste, and water management, among other issues. Thus, it is a challenge to achieve the dual goal of efficiently considering sustainability preferences while building investment solutions that help meet investors' financial goals. One way to approach this challenge is to focus first on developing an investment methodology that emphasizes what research indicates are reliable sources of higher expected returns while also aiming to minimize unnecessary turnover and trading costs. For instance, this may mean starting with a broad universe of stocks ranging from very large companies to very small

Investors can express their sustainability preferences through participation in global capital markets.

companies, and then systematically pursuing higher expected returns by increasing the weights of those securities with smaller market capitalizations, lower relative prices, and higher profitability.<sup>1</sup>

Next, investors can evaluate those companies being considered for investment using a focused set of environmental issues that reflect their primary concerns. By using a holistic scoring system, rather than a completely binary "in" or "out" screening process, investors may be able to preserve diversification while recognizing those companies with positive environmental profiles. This involves looking at companies across the entirety of a portfolio and within individual sectors with the goal of incorporating sustainability preferences while also maintaining the characteristics of the original strategy. For example, if one is trying to reduce a portfolio's greenhouse gas emissions and potential emissions from fossil fuel reserves, the worst offenders across all industries may first be deemphasized or excluded from the portfolio

1. Profitability is measured as operating income before depreciation and amortization minus interest expense scaled by book equity.

altogether. An across-industry comparison of this nature provides an efficient way to significantly reduce the aggregate greenhouse gas emissions per unit of revenue produced by companies within a portfolio with a minimal reduction in diversification. Next, companies may also be rated on sustainability considerations within each industry. This added level of scrutiny is recognition that, in the real economy, capital markets and the supply chain are highly interconnected. For example, a retail company may consume electricity from a utility company and transportation services from a trucking company, both of which are consumers of fuel from an energy company. Comparing companies within sectors recognizes this interconnectedness and can be used to overweight the most sustainable companies within a given industry. This could include retail companies that improve the energy efficiency of their facilities, utilities that produce electricity using solar or wind power, trucking companies that improve the fuel efficiency of their fleets or use alternative-fuel vehicles, or energy companies that increase efficiency, reduce waste, and improve their overall environmental footprint. On the other hand, companies with poor environmental sustainability ratings relative to industry peers may receive a lesser weight or may be excluded.

Using such a combination of company selection and weighting may allow for substantial reduction in exposure to greenhouse gas emissions and potential emissions from fossil fuel reserves—important goals for many investors—while providing a robust investment strategy that is broadly diversified and focused on the drivers of expected returns.

### CONCLUSION

The key takeaway for investors is that investing well and incorporating values around sustainability need not be mutually exclusive. Using a patented investment methodology, Dimensional has effectively implemented sustainability strategies with this dual goal in mind for more than a decade.<sup>2</sup> By starting with a robust investment framework, then overlaying the considerations that represent the views of sustainability-minded investors, this allows for a cost-effective approach that provides investors the ability to pursue their sustainability goals without compromising on sound investment principles or accepting lower expected returns.

## A SUGGESTED APPROACH TO SUSTAINABILITY INVESTING

1	Apply a methodology that emphasizes the sources of higher expected returns while minimizing unnecessary turnover and trading costs.
2	Systematically evaluate company sustainability metrics across all major industries.
3	Emphasize investment in companies acting in more environmentally sound ways than their industry counterparts.
4	Exclude or underweight companies based on other key environmental and social considerations while maintaining broad diversification.

2. Dimensional's approach to sustainability investing is protected by U.S. Patent Nos. 7,596,525 B1, 7,599,874 B1 and 8,438,092 B2.

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Diversification does not eliminate the risk of market loss. There is no guarantee an investing strategy will be successful. Investment risks include loss of principal and fluctuating value. Sector-specific investments can also increase these risks. Environmental and social screens may limit investment opportunities.

Small and micro cap securities are subject to greater volatility than those in other asset categories.

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