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*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 assess environmental, social and governance (ESG) factors as part of the investment process.

Many studies have attempted to answer this question, and their conclusions have been inconsistent. Some 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 ESG 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<sup>1</sup>.

We calculate the ESG score using external data sources (e.g., MSCI, Sustainalytics\*) 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



Source: MSCI.

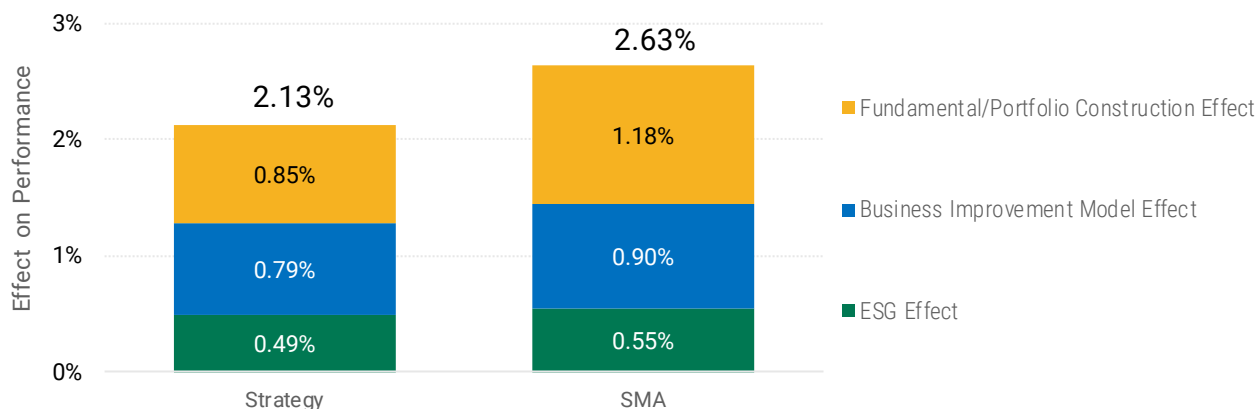
\*Sustainalytics is a firm that produces environmental, social and governance (ESG) research on public companies.

**Figure 1** illustrates ESG attribution results for American Century Investments' U.S. Sustainable Large Cap Core strategy (80-100 stocks) and the more concentrated U.S. Sustainable Large Cap Core SMA portfolio (40-50 stocks) since the strategies' inception more than five years ago.

This attribution analysis clearly illustrates the positive ESG effect for these strategies relative to the S&P 500® Index since inception. The green segments represent 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 Since Inception



Source: FactSet. Data from 7/1/2016 to 12/31/2021. Periods greater than one year have been annualized. Performance in USD, gross of fees. Performance attribution for the SMA is comprised of U.S. Sustainable Large Cap Core strategy attribution from 7/1/2016 to 6/30/2018 and U.S. Sustainable Large Cap Core SMA attribution from 6/30/2018 forward.

**Past performance is no guarantee of future results.**

### ESG Doesn't Exist in a Vacuum

ESG is just one of many 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 fundamental insights 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 segments, 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, ESG 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 examples illustrated in this paper show that for the large U.S. companies in these portfolios, being an ESG leader based on our scoring methodology was a tailwind. 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 Quarter-End	1 Year (%)	3 Years (%)	5 Years (%)	Since Inception* (%)
U.S. Sustainable Large Cap Core - Net Return	29.23	27.56	19.74	19.57
U.S. Sustainable Large Cap Core SMA - Net Return	28.89	24.92	17.57	17.41
U.S. Sustainable Large Cap Core - Gross Return	29.62	28.10	20.56	20.46
U.S. Sustainable Large Cap Core SMA - Gross Return	32.76	28.71	21.13	20.97
S&P 500® Index	28.71	26.04	18.46	18.25

Source: FactSet. Data as of 12/31/2021. Performance in USD. Periods greater than one year have been annualized. \*Inception date: 7/1/2016.

Beginning July 1, 2018, the composite includes all fully discretionary, separately-managed (wrap) portfolios as well as a proprietary account used as the SMA model portfolio. Performance results from inception through June 2018 are those of the Firm's U.S. Sustainable Large Cap Core Equity composite, which is comprised of 100% non-wrap type accounts and is managed using the same philosophy and strategy as the U.S. Sustainable Large Cap Core Equity SMA strategy, although the latter will generally hold fewer securities. **Past performance is no guarantee of future results.**

## Endnotes

<sup>1</sup> 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.

## Disclosures

*The vast majority of American Century's investment strategies are subject to the incorporation of ESG factors into the investment process employed by each strategy's portfolio managers. 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.*

*An investment strategy that focuses on Environmental, Social and Governance factors ("ESG") seeks to invest, under normal market conditions, in securities that meet certain ESG criteria or standards in an effort to promote sustainable characteristics, in addition to seeking superior, long-term, risk-adjusted returns. This investment 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 an ESG investment focus. ESG-focused investment strategies include but are not limited to impact, best-in-class, positive screening, exclusionary, and thematic approaches.*

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