September 06, 2018

Economics Group

Diane Schumaker-Krieg, Global Head of Research, Economics & Strategy
diane.schumaker@wellsfargo.com • (212) 214-5070
Tim Quinlan, Senior Economist
tim.quinlan@wellsfargo.com • (704) 410-3283
Sarah House, Senior Economist
sarah.house@wellsfargo.com • (704) 410-3282
Shannon Seery, Economic Analyst
shannon.seery@wellsfargo.com • (704) 410-1681

Value in Virtue: Impact Investing & the Economy

Executive Summary

While the purpose of investing is to maximize returns, the allocation of capital also shapes corporate behavior, and that has implications for the economy. When capital is deployed with consideration to factors beyond just financial returns, like contributing to a positive difference in the world…that is impact investing. It goes by other names: socially responsible investing (SRI), green- or sustainable investing, etc. Another moniker that has gained momentum is ESG, referring to firms that exhibit a commitment to Environment, Social and Governance values; examples of the sorts of ESG criteria are represented in Figure 1 on the next page.

While it is true that not every investor will be willing to place value on non-financial returns on investment, even financially motivated market participants will not want to overlook the fact that this fast-growing category of investment captures roughly 20 cents of every dollar invested. Even if one has doubts about the viability of investing in a values-based strategy, the fact that the category is gaining traction and capturing asset flows suggests that it will influence corporate decisions, and that translates into implications for the economy.

Impact investment captures roughly 20 cents of every dollar invested.

The current economic landscape offers a compelling backdrop for the *impact* part of impact investing to be manifested. In this special report, we look into how the ESG values that inform investment decisions could shape corporate behavior and what that means for three areas of the economy: the labor market, consumer spending and prices.

The labor market is as tight as it has been in decades and wage pressures are building. That backdrop affords businesses the opportunity to better align their priorities with what today's workers value to attract the best—and increasingly scarce—talent. Meanwhile, consumers' growing preference for values-based purchases has businesses changing up what is on-offer. Organic and fair-trade options at the grocery store are growing substantially faster than conventional food, while corporations who are prioritizing more than just profits, like those that promise to put shoes on the feet and shirts on the backs of the world's underprivileged people, are gaining market share. Not only are these companies differentiating themselves, but profits need not suffer; consumers are increasingly willing to pay up for goods and services from companies that are more committed to environmental, social and governance principles.

Values? Whose Values? Skip the Sermon and Give Me the Best Return

You do not have to be a believer in SRI in order for that approach to make a difference in the economy. In other words, you may be convinced as an investor that deeming a particular approach of investing to be "socially responsible" implies that other types are somehow not responsible and on that basis are completely arbitrary. That may or may not be true. For now, let us set aside the merits (or de-merits) of SRI and acknowledge that if enough people believe it is a worthwhile approach to asset management, it will have tangible effects on the economy by shaping corporate behavior, and that is what we discuss in this report.

This report is available on wellsfargo.com/economics and on Bloomberg WFRE.

SRI themes have broadened well-beyond the avoidance of "sin" stocks back in the 1990s. Corporations committed to ESG principles are on the receiving end of SRI fund flows. ESG values can drive revenues by helping companies attract the best workers, differentiate products and improve corporate strategy and monitoring.

Figure 1

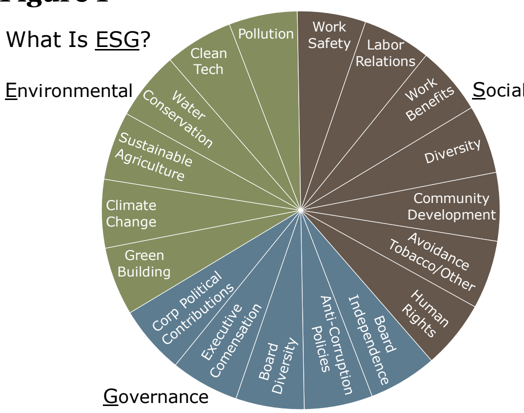
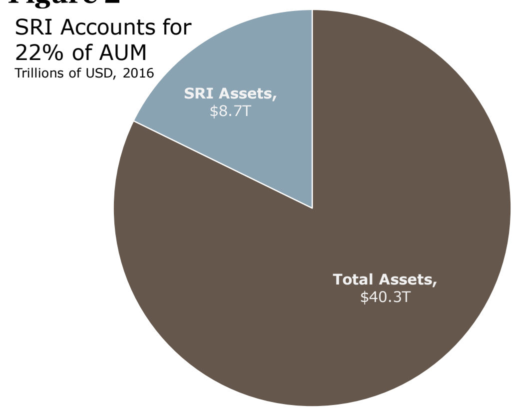


Figure 2



Source: U.S. SIF Foundation and Wells Fargo Securities

Environmental stewardship has come to the fore with eco-friendly products and services like tourism focused on sustainability. It is not just about new products or services, but extends to a company reducing its existing environmental footprint and better managing natural resources. Social considerations include investment in a company's community and supporting employees in their daily lives. Efforts to improve employee welfare and engagement come through creating a diverse and inclusive work environment, ensuring workplace safety and offering a range of health and lifestyle benefits. Companies are also being scrutinized on their approach to corporate governance. Aiming to improve oversight and transparency, governance issues being taken up include diversity, board independence, executive compensation and shareholder rights.

There is compelling evidence to support the notion that enough people believe in the concept. In fact, according to a 2016 report from the Forum for Sustainable and Responsible Investment, "as of year-end 2015, more than one out of every five dollars under professional management in the United States—$8.72 trillion or more—was invested according to SRI strategies."(Figure 2)[1]

Common Values: ESG and the Workplace

It is the underlying values embedded in SRI that are influencing the economy as much as the capital itself.

In a broad sense, it is the underlying values embedded in SRI that are influencing the economy as much as the allocation of the capital itself. So how might the ESG values that drive SRI influence the economy? From our perspective, the labor market is one spot where a shift in corporate behavior is most apt to manifest itself. Today's employees emphasize different values than prior generations. Companies that adapt to those preferences will be better positioned to attract the best talent and get the most out of their workforce.

Consider Millennials for example. No other generation will influence the U.S. economy more in the coming decades. Millennials already comprise the largest share of the labor force (Figure 3). The changing preferences of this group are only just beginning to influence the workplace and the labor market. Along similar lines to the values espoused in SRI, Millennials believe businesses should not only generate profit but also strive to improve society broadly, enhance the livelihoods of employees and protect the environment (Figure 4).[2] Millennials are more likely than Americans overall to report a company's social and environmental commitments factor into their decisions of where to work.[3]

[1] 2016 Report on U.S. Sustainable, Responsible and Impact Investing Trends. U.S. SIF Foundation.
[2] "Millennials Disappointed in Business, Unprepared for Industry 4.0." 2018 Deloitte Millennial Survey. Deloitte, 2018.
[3] 2015 Cone Communications Millennial CSR Study. Cone Communications, 2015.

Figure 3

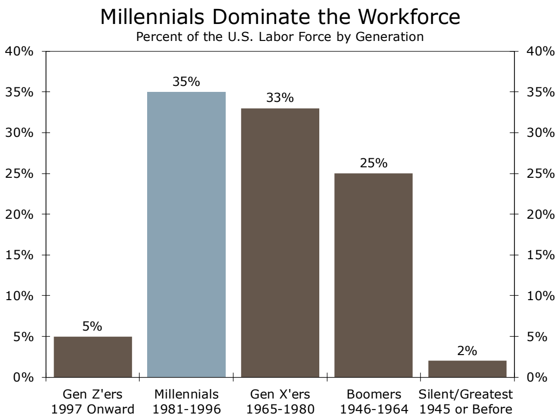
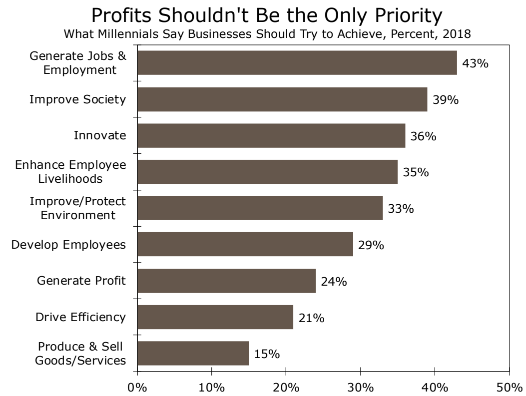


Figure 4



Source: Deloitte, Pew Research Center and Wells Fargo Securities

Given the size of the Millennial generation, creating a workplace culture that aligns with their preferences would position employers to attract this vital source of talent. But, creating a workplace environment more responsive to the needs of other key groups of workers can also give businesses an edge. Women are a prime example.[4] Women are out-achieving men educationally and hold a higher share of college degrees.[5] Yet labor force participation—which is strongly tied to educational attainment—remains 13 percentage points lower for women than men. The participation gap is widest for women in their 30s, when families are most likely to have young children (Figure 5). Married mothers who work full time still spend more time than married fathers on childcare and housework each day. It is not wholly surprising then that, more so than men, women rank having the opportunity to take time off for family needs as very important in a job (Figure 6).[6] Women are also more likely than men to view a job that helps society or has good benefits as extremely important.

Creating a workplace that aligns with shared values positions employers to attract Millennials.

Figure 5

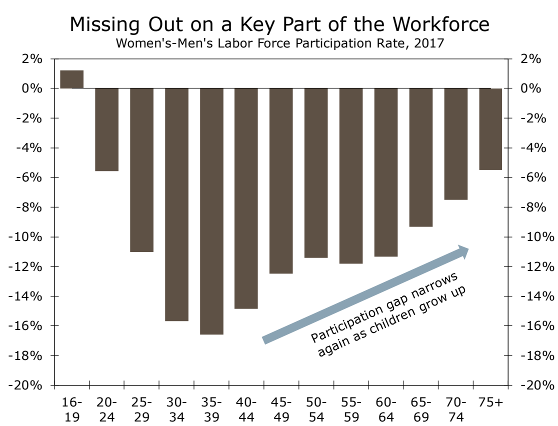
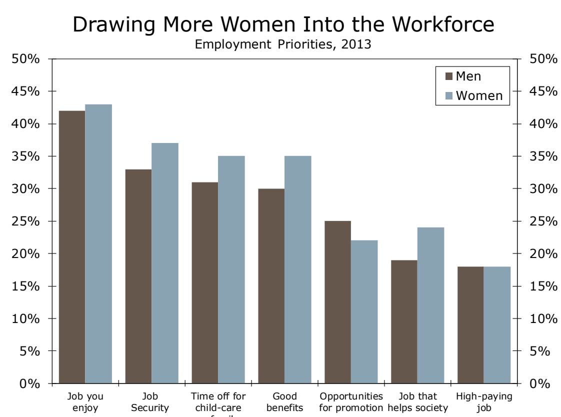


Figure 6



Source: Pew Research Center, U.S. Department of Labor and Wells Fargo Securities

Why Cater to Millennials' Workplace Whims? A Tight Labor Market.

By just about any reckoning, the U.S. labor market is historically tight. The unemployment rate, which dipped back under 4 percent in July, is just a couple of ticks away from lows last plumbed in

[4] Please see *The Girl With the Draggin' W-2*, sent to clients on Feb. 27, 2017.
[5] In 2017, 34.6 percent of women over the age of 25 held college degrees, versus 33.7 percent of men. Higher enrollment rates among women since the mid-1990s helped the share of women over the age of 25 who hold a college degree surpass that of men in 2014.
[6] "On Pay Gap, Millennial Women Near Parity – For Now." Pew Research Center, Washington, D.C. December 11, 2013.

the 1960s. The nearly five-decade low in jobless claims and record highs for job openings complete the picture. In other words, competition is fierce for workers. It also is likely to remain so beyond this business cycle, as growth in the working age population slows to a crawl (Figure 7).

If today's workers place more emphasis on social factors, could a company that embraces those principles pay below-market wages?

Pressed to find and retain good talent in such a tight market, employers have traditionally been compelled to raise wages. If Millennials are placing more emphasis on social considerations like employee welfare, could a company that embodies ESG principles attract workers at below-market rates? Doling out bigger paychecks weighs on profits, so attracting workers via nonfinancial means stands to benefit the company's bottom line. It could also cushion the company in the next downturn, as wages are also notoriously difficult to cut.

When push comes to shove, will younger workers actually accept a smaller salary if it means working for a company that supports environmental, social and governance principles? Millennials are frequently portrayed as a generation that places little emphasis on pay. However, financial compensation is still a high—if not the highest—priority for this group. Millennials cited pay as the most important factor for a job, according to a 2017 study by KPMG, while PWC found competitive wages ranked second among 13 categories thought to make an organization an attractive place to work.[7] The high emphasis placed on pay should not be entirely surprising since this generation is entering the workplace more indebted than any other group before them.

Figure 7

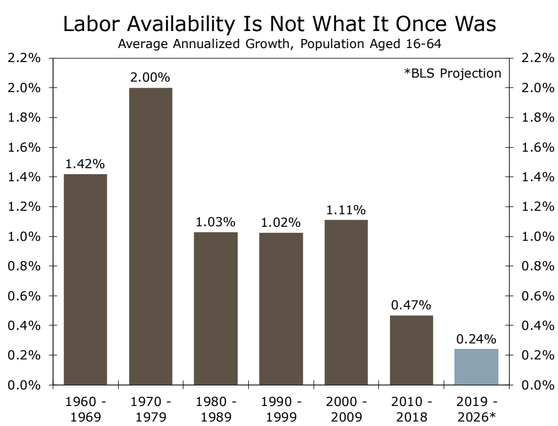


Figure 8

Source: Gallup Inc., U.S. Department of Labor and Wells Fargo Securities

Job satisfaction reduces absenteeism and turnover.

While pay is still an important factor, more Millennials than Boomers and Gen X'ers say they would switch jobs for a variety of perks like family leave, paid vacation and flexible work arrangements (Figure 8).[8] The more varied set of "social" priorities for this generation suggests more muted pressure on wages than would be the case in similarly tight conditions in prior cycles. Millennials are more likely to say they would choose to work for a socially responsible company, even if the salary would be less than at other companies.[9] A 2016 survey found that Millennials were, on average, willing to take a $7,600 pay cut for a job that provided purposeful work, work/life balance and better company culture.[10]

Of course, other programs aimed to enhance employee welfare (like family leave time or student loan assistance) would have costs. Yet there would be offsets beyond reductions to wages and salaries. It pays to keep your workers happy. A long history of research shows greater job satisfaction reduces absenteeism and turnover. Replacing a worker costs employers around 1/5 of an employee's annual salary.[11] The lost output of a departing worker, resources diverted to find a

---

[7] "Meet the Millennials." KPMG, June 2017.
"Millennials at work: Reshaping the Workplace." PWC, 2011.
[8] "State of the American Workplace." Gallup, 2017.
[9] 2015 Cone Communications Millennial CSR Study. Cone Communications, 2015.
[10] Fidelity Investments, "Evaluate a Job Offer Study." March 2016.
[11] Boushey, Heather and Sarah Jane Glynn. "There Are Significant Business Costs to Replacing Employees." Center for American Progress, Nov. 16, 2012.

replacement and lower productivity until the new hire gets up to speed all add up. Research also shows that employee engagement is positively associated with company performance.[12] In other words, what is good for employees can also be good for the bottom line.

Give Us This Day Our Daily Organic, Sustainably-Harvested Bread

Increasingly, people not only want to work for companies that share their principles, they want to do business with those sorts of companies as well. Today's consumers are increasingly demonstrating ESG values through their wallets. When we look at the way changing consumer preferences are remaking the aisles of the grocery store to the items on-offer from various retailers, it is evident that values-based consumer spending is changing the economy as well. Understanding the drivers behind these spending habits can help companies understand the evolving consumer and how to adapt to meet their changing tastes.

Values-based consumer spending is changing the economy.

Consumers today are asking more questions about where their products come from. Interest in the environmental, health and economic benefits of sustainable practices and products as well as transparency in the supply chain all show up in their spending.

A prime example of this trend is organic food sales, which are now a $40 billion market (Figure 9).[13] Some people buy organic products because organic fruits and vegetables are perceived to be tastier or of better quality, and admittedly those purchases would not be a pure expression of ESG values. But when a consumer selects organic for the purpose of avoiding pesticides or because of an objection to animals treated with growth hormones, then that selection does reflect ESG values. Although we cannot separate the intentions of buyers, the growth of the category is still an indication of the impact of ESG values.

Figure 9

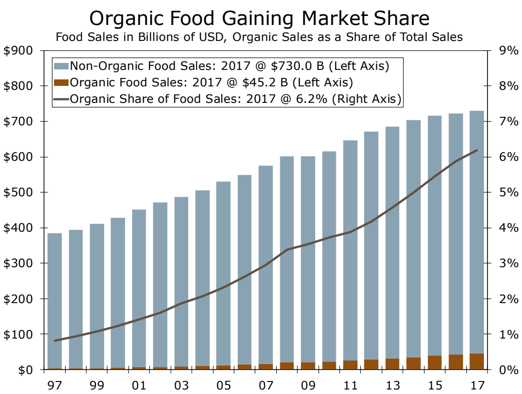
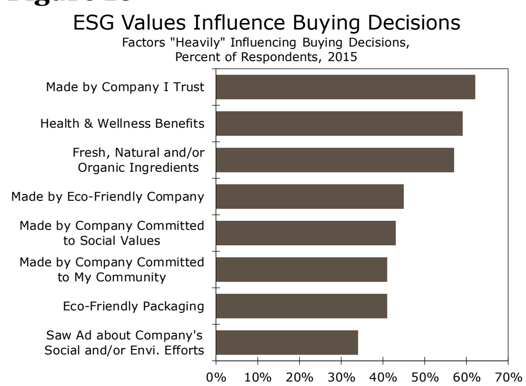


Figure 10



Source: U.S. Department of Agriculture, Organic Trade Association, Nielsen, Nutrition Based Journal and Wells Fargo Securities

Spending on organics is growing at five times the rate of conventional food; values-based preferences are already having a tangible effect.

While organic food today only captures about 6 percent of spending on food, the outlays on organic are handily outpacing conventional food. U.S. organic sales increased 6.4 percent in 2017 compared to the overall food market, which rose about 1.0 percent.[14] If organic food spending is growing at more than five times the rate of conventional food, values-based preferences are having a tangible effect on the real economy. That kind of growth will not go unnoticed by the investment community

[12] **Huang, Minjie, Pingshu Li, Felix Meschke and James Guthrie. 2015. "Family Firms, Employee Satisfaction, and Corporate Performance."** ***Journal of Corporate Finance*****, Vo. 34, Oct. 2015, pp. 108-127. Melián-González, Santiago, Jacques Bulchand-Gidumal, Beatriz González López-Valcárcel. 2015. "New Evidence of the Relationship Between Employee Satisfaction and Firm Economic Performance."** ***Personnel Review*****, Vol. 44 Issue: 6, pp. 906-929.**
[13] **U.S. Organic Industry Survey 2018. Organic Trade Association, 2018.**
[14] **We utilize USDA data for at-home food sales; however, 2015-2017 at-home food sales are calculated utilizing Nielsen data due to availability constraints. Organic Trade Association data is utilized for organic food sales.**

either. Warren Buffett once said that, "if a business does well, the stock eventually follows." A category of spending that grows five times faster than the rest of the sector will merit attention too.

There are also instances where adherence to a values-based approach yields superior economic outcomes. Recent research links prosperity at the county level to organic agriculture, and demonstrates that "organic food and crop production–and the business activities accompanying organic agriculture–creates real and long-lasting regional economic opportunities."[15] The implication here is that the underlying values behind the growth of organic food are demonstrably linked to better outcomes for businesses and communities.

Let It B

Corporate leaders are also taking action to be more transparent with the corporations' social initiatives. Companies often associated with societal and environmental priorities, such as Ben & Jerry's and Patagonia, have become certified as "B corporations", which are "businesses that are legally required to consider the impact of their decisions on their workers, customers, community, and environment."[16] This certification allows consumers to clearly identify corporations who are committed to environmental and social causes, making it easier for those interested to align their values with those of the firms they patronize.

Two thirds of consumers will spend more on a product if it comes from a sustainable brand.

While organic or sustainable products typically have an increased cost associated with their production, these distinctions would not necessarily squeeze a firms' bottom line. In fact, according to the 2015 Nielson Global Corporate Sustainability Report, 66 percent of consumers are willing to spend more on a product if it comes from a sustainable brand, a statistic that rises to 73 percent for the Millennial generation.[17]

There are many factors that play into purchasing decisions, but a majority of buyers are "heavily" influenced by factors that epitomize ESG values (Figure 10).[18] Not surprisingly, those that are willing to pay more for eco-friendly or socially responsible products are more likely to weigh those factors as "heavily influential" in their buying decisions. Consumers are demanding transparency in production and paying attention to corporate social practices, but are willing to pay a higher price in order to receive these certainties–enabling firms to pass on associated costs and raise prices.

Shifting more consumption to socially responsible goods stands to put upward pressure on inflation, at least in isolation. However, with a multitude of other factors influencing inflation, like e-commerce, exchange rates and expectations, it is unclear how the potential crosscurrents of wage concessions and buying habits would play out. Moreover, even if companies would not *need* to raise prices to maintain profit margins, it does not mean they would not take advantage of any pricing power if it were available.

Conclusion: Invest or Don't Invest, but ESG Is Shaping the Economy

It is not only investors who are considering more than a company's bottom line. Workers and consumers today are thinking more about businesses' environmental, social and governance values when deciding where to work and who to buy from. ESG does not need to come at the expense of profits. Companies that demonstrate their commitment to ESG will be better positioned to attract increasingly scarce labor—quite possibly at a discount. At the same time, ESG serves as a way for companies to differentiate their product and gain market share, even at a higher price point since consumers are willing to pay up for values-based products. What is good for the environment, society and governance need not alter the bottom line, but it is altering the job market and consumer spending.

[15] **"Organic Hotspots." Organic Trade Association.**
[16] **"The B Economy." Certified B Corporation.**
[17] **2015 Nielsen Global Corporate Sustainability Report. The Nielson Company, 2015.**
[18] **"The Sustainability Impetrative." 2015 Nielsen Global Corporate Sustainability Report. The Nielson Company, 2015.**

Wells Fargo Securities Economics Group

Diane Schumaker-Krieg	Global Head of Research, Economics & Strategy	(704) 410-1801 (212) 214-5070	diane.schumaker@wellsfargo.com
Jay H. Bryson, Ph.D.	Global Economist	(704) 410-3274	jay.bryson@wellsfargo.com
Mark Vitner	Senior Economist	(704) 410-3277	mark.vitner@wellsfargo.com
Sam Bullard	Senior Economist	(704) 410-3280	sam.bullard@wellsfargo.com
Nick Bennenbroek	Currency Strategist	(212) 214-5636	nicholas.bennenbroek@wellsfargo.com
Azhar Iqbal	Econometrician	(704) 410-3270	azhar.iqbal@wellsfargo.com
Tim Quinlan	Senior Economist	(704) 410-3283	tim.quinlan@wellsfargo.com
Sarah House	Senior Economist	(704) 410-3282	sarah.house@wellsfargo.com
Charlie Dougherty	Economist	(704) 410-6542	charles.dougherty@wellsfargo.com
Erik Nelson	Currency Strategist	(212) 214-5652	erik.f.nelson@wellsfargo.com
Michael Pugliese	Economist	(212) 214-5058	michael.d.pugliese@wellsfargo.com
Ariana Vaisey	Economic Analyst	(704) 410-1309	ariana.b.vaisey@wellsfargo.com
Abigail Kinnaman	Economic Analyst	(704) 410-1570	abigail.kinnaman@wellsfargo.com
Shannon Seery	Economic Analyst	(704) 410-1681	shannon.seery@wellsfargo.com
Matthew Honnold	Economic Analyst	(704) 410-3059	matthew.honnold@wellsfargo.com
Donna LaFleur	Executive Assistant	(704) 410-3279	donna.lafleur@wellsfargo.com
Dawne Howes	Administrative Assistant	(704) 410-3272	dawne.howes@wellsfargo.com

WELLS FARGO SECURITIES