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September 1, 2021

DSC Meridian ESG Leader, Spotlight Series: Featuring Erika Karp, Chief Impact Officer, Pathstone



Paula Luff
Director of ESG
Research &
Engagement

Executive Summary:

Erika is a globally recognized thought leader on environmental, social, and governance (ESG), impact and the capital markets. She is the Chief Impact Officer at Pathstone, an independent family and partner owned advisory firm. She joined the Pathstone team from Cornerstone Capital Group (acquired by Pathstone in 2021), the sustainable and impact investment advisory firm she founded in 2013.



Erika Karp
Chief Impact
Officer

Prior to launching Cornerstone, Erika was Managing Director and Head of Global Sector Research at UBS Investment Bank. She chaired the Global Investment Review Committee, served on the UBS Securities Research Executive Committee, and served on the Environmental and Human Rights Committee of the UBS Group Executive Board.

Erika holds an MBA in Finance from Columbia University and a BS in Economics from the Wharton School. She was a founding board member of the Sustainability Accounting Standards Board (SASB) and recently joined the Board of Directors of Conscious Capitalism.

Erika recently sat down with us as part of our ESG spotlight series, covering topics from ESG risk and opportunity to the capital markets and climate change.

Opinions expressed herein are the own opinions of Ms. Karp and Ms. Luff and are not necessarily the opinions of DSC Meridian Capital LP or Pathstone Family Office LLC or their respective partners, employees or affiliates. The interview has been edited for clarity.

ESG: FROM RISK TO OPPORTUNITY

Paula Luff (PL): Erika, you came up through Wharton and Columbia Business School. You spent over two decades on Wall Street in traditional finance roles. How and when did you start thinking about what is now called ESG or impact investing?

Erika Karp (EK): I came to it organically. As director of global sector research at UBS Investment Bank, working with global analysts across industries and regions, I learned that ESG factors truly help contribute to successful investment outcomes. I pushed analysts to go down different avenues of inquiry to find predictive insight. I think ESG factors must be part of an investor's decision-making process.

Once you learn what matters in the realm of ESG analysis, you just want to learn more. You can't go back. And I want to push very hard to not use ideological or divisive or political language. It's very important that it's about analytics. It's about fundamentals, it's about costs and revenues and risk. Making it fundamental as opposed to ideological makes all the difference in the world for investments.

PL: In addition to making the fundamental case, how do you change the conversation from risk to opportunity with ESG and impact investing?

EK: To shift gears and talk about opportunities rather than just risk, you have to look at things holistically. For some companies, that "E", that environmental issue, may be pure risk, but in just as many companies it's an opportunity to find solutions. That's a forward-looking, critical element of ESG analysis. If we're talking about climate change, sure—you can just take that as worrying about carbon pricing, because that's a risk. Or, you can invest in solutions.

So, the question really is: how do you see it? Let's look at the financial services industry and discussions in governance about data privacy. Well, that can purely be a risk, certainly. Or it can be an opportunity for a business model that is built on trust. So, you can see the opportunity to gain market share if you are really strong in governance. Every sector has its risks and opportunities. It's a matter of thinking long-term, for one. And it's a matter of knowing what is material.

LEADERSHIP, LEGACY AND COMPETITIVE RETURNS

PL: I think that's right, and I think the idea of long-term is an interesting one. Most CEOs' tenure is what, ten years or so? And by nature, focusing on climate change, for example, takes longer than a ten-year vision. What kinds of changes do you think will get boards, CEOs and management teams to think about long-term value creation as opposed to focusing on the next quarter? Do you see anything shifting here?

EK: I think it's shifting somewhat, though not enough. You have to remember that it is not just the CEO's incentivization that is critical, it's incentive structures throughout the organization. The reality is we need the boards, not just the CEOs, to be accountable. I think most boards are not as well-versed in sustainability and ESG as they should be.

If you have the right board you get better incentive alignment for the CEO. And we still have a lot of work to do, in terms of boards and directors and board accountability. We are in desperate need of board renewal. But frankly, I think we have the wrong CEOs if they're not thinking long-term.

I think we are moving to a place where corporations, CEOs and boards, are starting to think more about legacy. There's a quote from Shakespeare, that "no legacy is so rich as honesty." That's really applicable here, because over the last couple of decades, we've seen a loss of confidence in our institutions. I think we must get back to honesty, then I think CEOs will think more about their legacy. And then we start to think more in terms of the long-term.

PL: Agreed. Since the financial crisis, really, trust in institutions, even NGOs, has been eroding. There are still skeptics who say that you can't have it both ways: you can't have a sustainable portfolio or a portfolio built on impact and also enjoy competitive returns. I feel that's a myth.

EK: Yes, you still hear it. You also hear integrating ESG factors is in some way a breach of fiduciary duty. I believe that not only is that wrong, the reality is the opposite. If you don't look at material ESG factors with regard to performance, you are missing a key element of fiduciary duty in my opinion. Investors need not sacrifice anything to invest more consciously or sustainably. And by the way, some people will hear ESG referred to as "ESG investing" or as an asset class or a style. It is none of those things. ESG analysis is a discipline, and it's a necessary discipline for anyone involved in the financial markets, period. We have seen hundreds and hundreds of studies that show there is no give-up in returns to do ESG analysis. Why would you want less information, rather than more? Especially if it's material.

Remember, there's no single ESG factor that's compelling enough to base an investment decision on. Any ESG factor is a starting point for further inquiry. Skilled managers know how to use ESG data as a starting point and know how to do the further inquiry. Right now, we do have an issue with lots of people talking about

sustainable investing, and they don't know how to use the analysis (that they're probably not doing anyway). But the bottom line is, you sacrifice nothing by doing ESG analysis.

CAPITAL MARKETS AND CLIMATE CHANGE

PL: What is the role of the capital markets to mitigate climate change? We often hear, "Well this is really the purview of government, or there are nonprofits or foundations like the Gates Foundation." But it seems that to flow enough capital to climate change, you can't rely on just a few sources of funding?

EK: It's critical. So just to give a sense, a couple years ago Bloomberg gave us a number that about \$500 billion had been invested in alternative energy sources. Now, we know, looking at the Paris Climate Agreement numbers, we need something like \$1.5 trillion to be invested to get us anywhere near the below 1.5 degree scenario. You can see the money that's flowing is nowhere near enough to solve for climate. If you want to throw in infrastructure and social justice, women's economic empowerment, and environmental issues such as marine health and biodiversity, the number is close to \$7 trillion a year.

That kind of money is not going to come from any single sector. But certainly, we have got to see healthy capital markets in order to see a healthy economy, in order to have progress.

PL: Absolutely. Talk to us a little about the Sustainable Development Goals (SDGs). So many companies and investors are focused on advancing this blueprint for a sustainable planet yet many of the targets are not investable or relevant to the private sector. Can you talk a bit about Pathstone's Access Impact Framework?

EK: I agree with you entirely, the SDGs are not investable in and of themselves. We're talking about no hunger, no poverty, and life above the seas, life below the seas, and healthcare and infrastructure—and world peace, I believe is number 16, and 17 is about collaboration, which is really important. I would say that they are too big, but I like audacious goals. But being not investable, what we need are stairways to get to them.

At Pathstone, we have something called the Access Impact Framework. Access is arguably a single common denominator among all the SDGs. To achieve them, we have to understand how interrelated and complex and nuanced these goals are. Intersectionality is so critical. If you use our access as the lens, we can get a lot more done—it's pragmatic.

For instance, you want access to women's economic empowerment and equality, which is SDG #5. You can't just go for number 5, right? We have to think about that. If you want SDG 5, we need access to capital, education, healthcare, water. You need access to all of these things that allow you to get to women's economic empowerment. We've created this framework that allows us to understand the intersectionality. We look at access by industry, sector, stock, and asset manager, and we can assess pragmatically, "This manager is giving us access to these SDGs." We then try to align our clients' values with their capital, with their assets. This framework gives us something like heat maps that are very user-friendly in terms of understanding, "Where's my money going?"

PL: How would you apply the Access Impact Framework to SDG #13 or climate change?

EK: This is so complex, because when we think about climate change it touches everything. Right? Everything. Climate change is arguably the genesis of wars in some cases. And there's a

clear connection between climate change and health. Climate change also disproportionately affects people of color, affects women. That interrelatedness is what we think about when looking for solutions, and to do so, we have to envision the future state of the economy and think about what we need to fix, and which strategies get us there. This is very complicated stuff.

PL: What I really like about this framework is that it picks up on the fact that SDGs themselves are so interconnected. You can't have an impact on climate change without having an impact on resource transformation or life on land, life below the seas—it's all interconnected.

EK: We've done a couple pieces that explicitly show the connection, including "the climate determinants of health" and "the climate determinants of financial services." We did a meta-study to show the systemic financial risks of what climate change called "No Place to Hide? Climate Change and Financial Risk" that reveals how the systemic risk touches every industry—through the value of assets and the destruction through the pricing of insurance, through what's out of people's pockets and how much money they have to spend on consumption. That's the systemic risk; no industry is unaffected.

PL: I couldn't agree more. We think about COVID as being a huge disruptor, and it is. But we like to say around here that there's a vaccine for COVID. Climate change will transform the energy ecosystem, consumer behavior, allocator decision making, capital flows, and company strategy. I've heard you say many times, capitalism is this economic system that created the greatest prosperity in the history of mankind. Albeit with inequities, and unintended consequences like climate change.

EK: Capitalism, instead of being extractive, can be regenerative and inclusive. Some people see sustainable investing in terms of risk mitigation. If you look at the markets, what was so interesting about last year is that we saw a big sell-off—of course, sustainability funds sold off less—but when the markets rebounded, we again saw these [sustainability] strategies outperform. That part we didn't expect so much. So, we thought, "Wow, these stocks, these managers are outperforming both ways. What's that about?"

We saw COVID accelerate some trends that were already in place, like telemedicine, distance learning, and remote work. We also saw that sustainability-oriented managers and companies are innovative and possibly more resilient. I think that sustainable investing and ESG analysis allows you to get to investments that are a proxy for quality. Over the long run, I think most people would want to see quality in conjunction with growth and innovation and resilience.

PL: You were a founding board member of SASB. On the heels of the work in Europe, including the EU taxonomy or the Sustainable Finance Disclosure Regulation (SFDR), the U.S. regulators—the SEC, the CFTC, the Federal Reserve and Treasury Department—are taking a fresh look at ESG. I'd love your thoughts on where this wave of regulator interest is going: do you think it's going to result in better data for us, better decision making for companies?

EK: I do. When we founded SASB in 2011, I felt compelled to join because I loved that it was sector based, provides different data points for different sectors, and is about materiality, what matters. I loved that it was a pragmatic implementation of the GRI, which was the gold standard at that time. I still love the SASB and I'm very proud of the work we did.

I also think it has led to an acceleration of the standards for disclosure by corporations. Right now, of course, I'm focused on what the SEC is doing. We're starting to see the SEC hold accountable those who are saying they're doing sustainable investing. I think this is going to take a while, because I think the SEC itself has a lot of learning to do. About 8 years ago, I went to the SEC proactively, which was unusual at the time. It's not often that you see someone from an investment bank raising their hand to go talk to the SEC. I wanted to talk specifically about the systemic financial risk and sector-based data. While I do think we're getting closer, it's going to take some time. With SASB, we decided to just keep pressing on, even though we weren't immediately going to get that imprimatur. I think enormous progress is happening very quickly, because this kind of grassroots demand has been building. I think we're going to get better and better data. I think AI is going to help us collect better data. We're going to be able to turn a massive amount of noise into insight.

PL: I think so too. I'm glad SASB stayed alive despite the disappointment at the SEC several years ago. The beauty of SASB is it gives resource constrained companies a handful of metrics to focus on. In most cases, even a small company with almost no human resources to devote to this type of work can do that. And I think it increases the likelihood that the work is integrated with what they do as opposed to what they say they're doing.

EK: Coca-Cola has told us they get about 300 inquiries per year for different surveys and studies and everything else on ESG data. There's one survey, in particular, of those that is 600 person hours for them to do. Now, Coca-Cola has some resources to do this, but even they don't want to, and so again the pragmatism is what's so important.

You know what else is interesting? Many people know George Serafeim from Harvard. He did a study called “Corporate Sustainability: First Evidence on Materiality” [co-authored with Mozaffar Khan and Aaron Yoon, 2015] that revealed exactly what you would expect in terms of performance and sustainable companies. But what was most interesting to me is that it showed the underperformance of companies that give lots of data that is not actually materially relevant to their profit outcomes and economic outcomes. I thought that was really fascinating.

This is a way to look at greenwashing as wasting investor money and time on information that is not necessarily related to any given investor and their values, whether they want to invest in a company. It’s the job of the investment advisor to lay it all out and make sure that clients are getting the insight they need based on whatever their values happen to be. So that pragmatism is just so important.

PL: Does Pathstone have a set of expectations of asset managers with respect to their focus on climate change or integration of ESG? How do you see that evolving? What kinds of conversations are you having with managers right now?

EK: This is a fascinating subject. Every one of the managers we look at through our due diligence research team, everyone is getting questions around ESG factors. We are absolutely trying to understand the ESG factors that are being deployed. We use some outside data, Sustainalytics, for example, then we enhance that, focusing on the sector, the region, the market cap. We do a lot of adjustments to the ESG data to give us reporting capability. Then we infuse that to work with the Access Impact Framework. The fact is that almost every single one of our clients—and we have roughly \$25

billion in assets under management—have expressly talked about sustainability.

PL: What do you think is the true role of asset management in climate change?

EK: I don’t think it runs that risk at all. Because climate touches everything, I don’t believe that an asset manager can be doing great work for the long term without thinking about what’s going on with climate. With every sector, in every region, in every industry, every company, nobody is disconnected from climate. Any asset manager that is thinking forward must be thinking about climate change. We talked about ESG as a proxy for innovation, for growth, for quality. If I run into a manager who can’t give me good answers related to climate change, climate risk, climate opportunities—I’m done, there’s no interest.

PL: Because ESG disclosure is limited in our investment universe, we see engagement with companies as vital to our underwriting and investment conviction. Are you seeing more strategies that rely on engagement?

EK: Absolutely. For some of the asset managers that we speak with, engagement will be an entirely differentiating factor for them. That’s the plan, actually: understanding how to engage. You, Paula, have that unique expertise to understand how to engage. When it comes to our questioning of managers, knowing that our managers are going to be pushing those companies and engaging, what we look for is intellectual curiosity, in particular lateral thinking. When we question our managers, we want to understand their process. What data point would trigger what questions to that manager when they go to the companies? And when it comes to engaging with a management team, if that management doesn’t understand lateral thinking, then that’s not a company that we would want.

PL: I know we're coming up on time, but I would love your thoughts on the Exxon annual meeting [activist shareholders obtaining board seats] and the court ruling in the Netherlands with Shell [court orders Shell to cut emissions]: where do you see the world going?

EK: They are big wins, right? It's huge in terms of showing us exactly where the world is going. There are two things that I think are so critical: one, transparency, and the other, which I think has been undervalued, is authenticity. With transparency, it is really hard to be disingenuous.

This is very encouraging. The issue is, it's just sad that there have been such horrifying object lessons before we got to this progress. The West is on fire, the central U.S. is a desert, there shouldn't be tornadoes in Brooklyn. The question is: do we have time? Mitigation is not enough. Do we have time to truly figure out how to repair the damage that's been done?

LEARN MORE

If you would like to learn more about DSC Meridian, please contact:

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