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# The active edge in sustainable investing

The challenges of 2020 have given us an opportunity to test our processes and performance in an extreme set of conditions. During this time, our active investment and sustainable investing strategies have fared well. We believe that active, fundamental research is key to unlocking differentiated insights and creating alpha for all strategies. The potential benefits are even more clear for sustainable investing, where underlying environmental, social, and governance (ESG) data is still evolving, and context matters greatly.

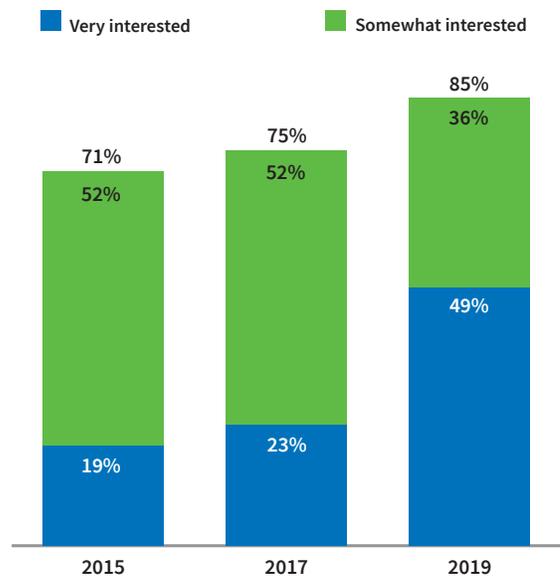
## Sustainable funds have outperformed their traditional peers

According to findings by the Morgan Stanley Institute for Sustainable Investing, U.S.-based sustainable equity funds outperformed their traditional peers in 2019. Also in the extremely challenging first half of 2020, U.S.-based sustainable funds outperformed traditional funds by an even wider margin. The Morgan Stanley report draws on analysis of more than 11,000 mutual and exchange traded U.S.-domiciled funds.

FIGURE 1

## Rising interest in sustainable investing

A growing number of individuals say they are “very interested” in sustainable investing, according to surveys from the Morgan Stanley Institute for Sustainable Investing.



Source: Morgan Stanley.

### Focus on inclusion is key to alpha and impact

Putnam’s two sustainable strategies have delivered strong performance, particularly through the difficult market environment in 2020. Both funds outperformed their benchmarks by a significant margin for the one-year period ended September 30, 2020.

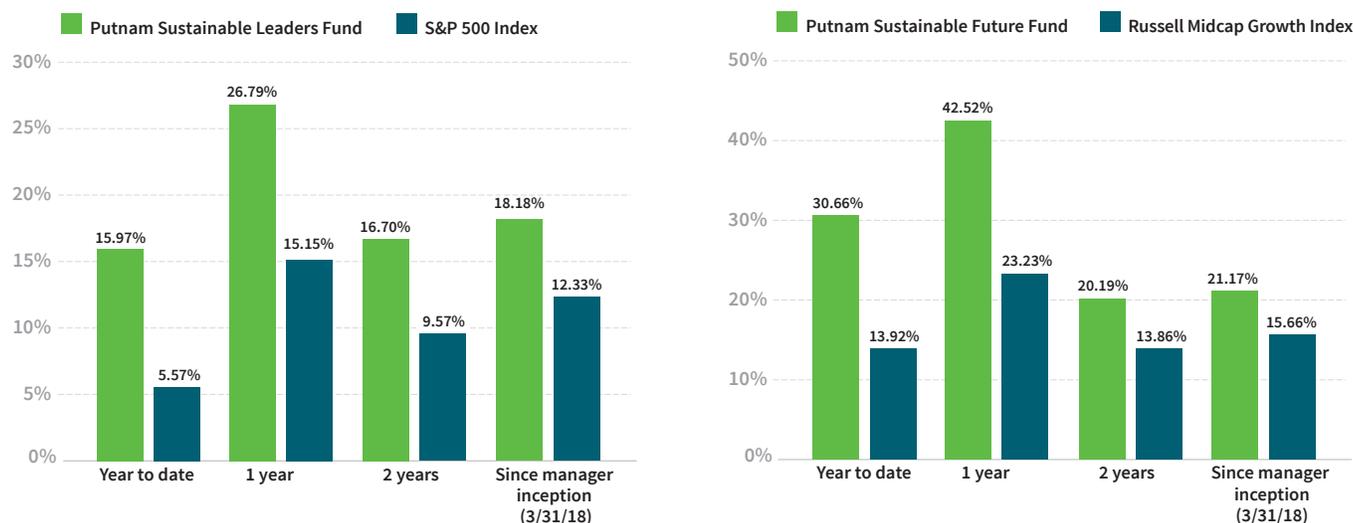
As active managers, we take an inclusionary approach and seek out companies where a leading sustainability strategy is fueling financial outperformance. One example is First Republic Bank, where a strong culture leads to lower employee turnover, higher referral rates, and more sustainable loan growth.

“ We seek out companies where a leading sustainability strategy is fueling financial outperformance. ”

Within the sustainable investment landscape, many passive strategies take an exclusionary approach that eliminates exposure to certain types of businesses, while other passive strategies take a “best-in-class” approach that aims for sector-neutral portfolio construction by owning stocks with the highest sustainability ratings within each sector or industry. For example, one of the largest passive ESG exchange-traded funds (ETFs) available today holds shares in Exxon and Chevron, two of the world’s largest publicly traded hydrocarbon producers. Several of the other top passive ESG ETFs hold shares in other large global hydrocarbon producers such as Saudi Arabian Oil Company, NK Lukoil, and others. This is because the investment process for passive ETF portfolios is typically based on owning higher relative rated companies and/or incorporating assessments of ESG corporate practices.

FIGURE 2

## Strong performance from Putnam’s sustainable strategies



Data as of 9/30/20. Sources: The S&P 500 Index is an unmanaged index of common stock performance. The Russell Midcap Growth Index is an unmanaged index of those companies in the Russell Midcap Index chosen for their growth orientation. Frank Russell Company is the source and owner of the trademarks, service marks, and copyrights related to the Russell Indexes. Russell® is a trademark of Frank Russell Company. You cannot invest directly in an index.

Current performance may be lower or higher than the quoted past performance, which cannot guarantee future results. Share price, principal value, and return will vary, and you may have a gain or a loss when you sell your shares. Performance of class Y shares assumes reinvestment of distributions and does not account for taxes. Class Y shares, available to investors through an asset-based fee program or for institutional clients, are sold without an initial sales charge and have no CDSC. Sustainable Leaders total expense ratio: 0.78%; Sustainable Future total expense ratio: 0.82%. For the most recent month-end performance, please visit putnam.com.

In contrast, our forward-looking fundamental approach, which is focused on long-term trends and company-specific business analysis, helps us to identify companies like AES, a global power company proactively transitioning power generation from hydrocarbons to renewable energy. The stocks of large hydrocarbon producers have underperformed in recent years in part due to the industry's transition to lower cost renewable energy sources, whereas AES stock had a one-year gain of 14.81% as of September 30, 2020. Of course, an active approach does not always lead to such divergence in performance, but this example illustrates the potential benefit of investing in companies that are leading sustainability trends like the shift to renewable energy.

### Considering companies of all sizes

As active managers, we are also able to seek opportunities in smaller, faster-growth companies. We seek those that are creating innovative and impactful solutions that we believe will drive investment performance. Many passive strategies rely at least in part on third-party ESG ratings, which tend to favor larger-cap companies. Larger companies have more resources to devote to ESG disclosure, which tends to lead to higher scores. Smaller companies with fewer resources often have lower, or incomplete, scores from third-party data providers. Yet these smaller companies can also have products or services that might be tied to powerful sustainability themes, driving potentially faster growth.

This dynamic can also be seen with newer companies, and especially with recent IPOs. Our ability as active managers to incorporate timely and less-structured ESG information before it is reflected in third-party scores or other structured data sources is essential. Without this approach, our shareholders might miss out on the potentially strong performance and faster growth of smaller or newly public companies that focus on sustainability solutions.

“As active managers, we are able to incorporate timely and less-structured ESG information before it is reflected in third-party scores.”

According to Bloomberg, the average ESG disclosure score for small-cap companies is nearly 20% lower than that of large-cap companies. Within the Russell 1000 Index, 90% of the larger companies (top half of the index based on market cap) published sustainability reports, while only one third of the smaller companies did the same.

This disclosure dynamic translates to some surprising and counterintuitive results at the company rating level. Using one third-party data provider's methodology, for example, many investors would be surprised to learn that Imperial Brands, one of the largest public tobacco companies, scores better than Novartis, a pharmaceutical company developing lung cancer therapeutics. This is due in part to differences in the volume of ESG disclosures. As active investors, we also consider the substance of the business, the company-specific sustainability strategy and forward looking goals, and how all of these elements are linked to financial performance.

“We consider the substance of the business, the company-specific sustainability strategy and forward-looking goals, and how all of these elements are linked to financial performance.”

### We learn from the past, but are focused on the future

Often, the ratings and data that help inform ownership in passive products are based on historical data. A company's disclosure on greenhouse gas emissions over the past five years is likely not the determining factor for financial performance — or environmental progress — over the next five years. Our approach allows us to use valuable historical and external ESG data as context for considering future prospects.

With an understanding of history, we can analyze future potential in areas like resource intensity, strength of corporate culture, and ability to invest future cash flows wisely. All of these elements are harder-to-quantify, forward-looking ESG characteristics that can meaningfully impact future fundamental performance.

## Our sustainable strategies

**In our portfolios, we pursue excellence in sustainability performance that is intrinsically linked to excellence in financial performance.**

### Putnam Sustainable Future Fund

- Our emphasis for this fund is on solutions-oriented companies that offer innovative ways to address our greatest sustainability challenges.
- The stocks of these companies are typically, but not always, considered to be growth stocks, and often are mid-cap or small-cap in size.
- We seek to invest in products and services that result in positive environmental, economic, or social impact.
- By providing these solutions, the companies in the portfolio offer potential for strong financial growth and profitability, in our view.

### Putnam Sustainable Leaders Fund

- With this fund, we seek companies with strong fundamentals that are linked to leadership in financially material sustainability issues.
- The stocks of these companies are typically, but not always, considered to be growth stocks, and in most cases they are large-cap in size.
- We look for performance that demonstrates true leadership, not just compliance, in areas such as clean and efficient materials use, reductions in carbon or water intensity, improvements in workplace equality and diversity, and alignment of management incentives.
- We invest in companies where strength in relevant sustainability issues is increasing their long-term business potential.
- By focusing on material ESG issues for each individual business, we aim to identify companies with durable financial performance and potentially lower risk profiles.

## The active advantage

We believe that thoughtful fundamental analysis is required to identify the relevant and financially material sustainability issues that will impact the future performance of a given company. By taking an integrated fundamental approach to research, we seek to identify companies where sustainability leadership and innovative solutions will contribute to long-term financial success. Our active portfolios therefore pursue excellence in sustainability performance that is intrinsically linked to excellence in financial performance. In our view, this forward-looking fundamental approach gives us a distinct advantage.

“ We seek to identify companies where sustainability leadership and innovative solutions will contribute to long-term financial success. ”

## Putnam Sustainable Leaders Fund

Annualized total return performance as of 9/30/20

Inception 7/19/94	Class Y shares	S&P 500 Index	Russell 3000 Growth- S&P 500 Linked Benchmark
1 year	26.79%	15.15 %	15.15%
3 years	18.51	12.28	14.68
5 years	18.40	14.15	15.87
10 years	15.70	13.74	15.12
Life of fund	12.41	10.38	10.21

## Putnam Sustainable Future Fund

Annualized total return performance as of 9/30/20

Inception 4/2/02	Class Y shares	Russell Midcap Growth	Russell 3000 Value - Russell Midcap Growth Linked Benchmark
1 year	42.52%	23.23%	23.23%
3 years	17.71	16.23	13.26
5 years	15.15	15.53	14.33
10 years	14.25	14.55	13.22
Life of fund	11.13	8.30	7.80

Current performance may be lower or higher than the quoted past performance, which cannot guarantee future results. Share price, principal value, and return will vary, and you may have a gain or a loss when you sell your shares. Performance of class Y shares assumes reinvestment of distributions and does not account for taxes. Class Y shares, available to investors through an asset-based fee program or for institutional clients, are sold without an initial sales charge and have no CDSC. Performance for class Y shares before their inception are derived from the historical performance of class A shares (inception 11/1/99 for Sustainable Future Fund, 8/31/90 for Sustainable Leaders Fund), which have not been adjusted for the lower expenses; had they, returns would have been higher. Sustainable Leaders total expense ratio: 0.78%; Sustainable Future total expense ratio: 0.82%. For the most recent month-end performance, please visit [putnam.com](http://putnam.com).

The views and opinions expressed are those of the authors, are subject to change with market conditions, and are not meant as investment advice. As of 9/30/20, First Republic Bank represented 0.94% of Sustainable Leaders Fund assets and 1.84% of Sustainable Future Fund assets. AES represented 1.99% of Sustainable Leaders Fund assets and was not held in Sustainable Future Fund. The following stocks were not held in either fund as of 9/30/20: Exxon, Chevron, Saudi Arabian Oil Company, NK Lukoil, Imperial Brands, and Novartis.

The Russell 1000 Growth Index is an unmanaged index of those companies in the large-cap Russell 1000 Index chosen for their growth orientation.

The Russell 3000 Growth-S&P 500 Linked Benchmark represents performance of the Russell 3000 Growth Index through July 31, 2019, and performance of the S&P 500 Index thereafter.

The Russell 3000 Value-Russell Midcap Growth Linked Benchmark represents performance of the Russell 3000 Value Index through March 20, 2018, and performance of the Russell Midcap Growth Index thereafter.

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**Consider these risks before investing:** The value of investments in the fund's portfolio may fall or fail to rise over extended periods of time for a variety of reasons, including general economic, political or financial market conditions, investor sentiment and market perceptions, government actions, geopolitical events or changes, and factors related to a specific

issuer, geography, industry or sector. These and other factors may lead to increased volatility and reduced liquidity in the fund's portfolio holdings. Growth stocks may be more susceptible to earnings disappointments, and the market may not favor growth-style investing. Investments in small and/or midsize companies increase the risk of greater price fluctuations. International investing involves currency, economic, and political risks. Emerging-market securities have illiquidity and volatility risks. The fund's investment strategy of investing in companies that exhibit a commitment to sustainable business practices may result in the fund investing in securities or industry sectors that underperform the market as a whole or underperform other funds that do not invest with a sustainable focus. From time to time, the fund may invest a significant portion of its assets in companies in one or more related industries or sectors, which would make the fund more vulnerable to adverse developments affecting those industries or sectors. In evaluating an investment opportunity, we may make investment decisions based on information and data that is incomplete or inaccurate. Due to changes in the products or services of the companies in which the fund invests, the fund may temporarily hold securities that are inconsistent with its sustainable investment criteria. Our investment techniques, analyses, and judgments may not produce the outcome we intend. The investments we select for the fund may not perform as well as other securities that we do not select for the fund. We, or the fund's other service providers, may experience disruptions or operating errors that could have a negative effect on the fund. You can lose money by investing in the fund.

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