Interest in ESG and sustainable investing is immense and growing. A recent survey by the Morgan Stanley Institute for Sustainable Investing showed 85% of U.S. individual investors (and 95% of Millennials) now express interest in sustainable investing strategies, with almost all of those individuals specifically interested in tracking the impact return on their investments.¹ Millennials currently account for over 1/3 of the workforce and according to the U.S. Bureau of Labor Statistics, by 2030, Millennials will account for 75% of the workforce. Based on these projections, we expect interest in ESG and sustainable investing in the municipal bond market to continue to expand in a robust way.

We believe that the municipal bond market is a natural fit for incorporating an ESG framework into the investment process. One approach to municipal bond ESG investing focuses on negative screening. In our view, this is only modestly applicable in the muni market as traditional “sin sectors” such as tobacco, gambling and ammunitions only account for a very small portion of the market issuance outstanding. Other muni ESG investing strategies have focused on integrating ESG risk factors into making credit decisions. There is, however, the opportunity to expand on this approach by continuing to focus on long-term credit risks while additionally targeting investments that provide tangible community impact.

The muni market has recently started to embrace the growing green bond movement, steering funds towards important clean energy and safe drinking water projects and conservation initiatives. Bloomberg data shows that YTD labeled green bond issuance, while still a small slice of the overall muni market, has more than doubled to $8.2 billion (from $4.0 billion in 2018) and now totals $37.4 billion in issuance since the first green bond in Massachusetts in 2013. These investments support sustainable communities and must continue, in our opinion. Additionally, a more encompassing approach can broadly impact a population by directing capital investment beyond environmentally-friendly projects in order to provide core social services to underserved...
residents. Social benefits, which include investments in education and non-profit healthcare systems in disadvantaged areas, can be targeted by closely examining the use of bond proceeds and overlaying publicly available information about local demographics such as service area income levels, poverty rates and unemployment rates. We believe this strategy can achieve market returns without taking on additional risk by using a diligent portfolio management approach that implements sector and geographic diversification and leverages professional credit research capabilities.

There’s too much confusion…

With the many definitions of ESG – impact investing, socially responsible investing, principles based investing, etc. – there is confusion in the investor community as to what each approach really means. While the goal of this paper is not to say which approach is best (each approach in its own right works for different investment goals/objectives), we will describe our methodology and approach to ESG/impact investing in the municipal bond space. We hope that over time, our approach will be viewed as the benchmark for muni ESG/impact investing as we continue to evolve our process. First, let’s start by describing each aforementioned approach in more detail.

ESG integration

The United Nations’ Principles for Responsible Investment (PRI) defines ESG integration as “the explicit and systematic inclusion of ESG issues in investment analysis and investment decisions.” Simply stated, integration incorporates financial risk factors with the analysis of non-financial risk factors pertaining to Environmental, Social and Governance issues and applies them to the investment decision-making process. ESG factors are used to determine valuation beyond standard financial metrics such as profitability ratios and financial statement analysis. ESG integration is performance driven and seeks to improve risk-adjusted return.

Socially responsible investing/values-based investing

Socially responsible investing (SRI) or values-based investing differs from ESG integration in that it seeks to align an investor’s moral compass with investment return. SRI still seeks financial gain but focuses on narrowing (including or excluding) the investment universe to align with one’s values or beliefs. Many investors assume SRI focuses primarily on exclusionary or negative screens such as “cannot invest in tobacco revenue bonds” but SRI includes both positive (inclusionary) and negative screening to determine the investable universe. SRI also seeks financial gain, similar to ESG integration, but does so with alignment to an investor’s values/beliefs.

THERE IS NOT JUST ONE DEFINITION FOR ESG, AS STRATEGIES RANGE FROM LARGELY RETURN-FOCUSED ESG RISK MANAGEMENT TO PURE PHILANTHROPY

<table>
<thead>
<tr>
<th>Focus</th>
<th>Traditional</th>
<th>Values-based</th>
<th>ESG Integration</th>
<th>Market-rate</th>
<th>Concessionary</th>
<th>Philanthropy</th>
</tr>
</thead>
<tbody>
<tr>
<td>Limited or no focus on ESG factors of underlying investments</td>
<td>Focusses on screening to align portfolios with one’s values or beliefs</td>
<td>Focusses on incorporating ESG risk factors into investment decisions</td>
<td>Focusses on areas where social or environmental need creates an opportunity for municipal investors seeking a market-rate return</td>
<td>Focusses on areas where social or environmental need requires a financial trade-off</td>
<td>Focusses on areas where social or environmental need requires 100% financial trade-off</td>
<td></td>
</tr>
</tbody>
</table>

Source: DWS as of November 2019. For illustrative purposes only.
Impact investing

Impact investing focuses on positive impact primarily within environmental and social issues. Impact investment can be “market-rate” in which the investment strategy seeks to deliver alpha while targeting impact areas. Or impact investing can be “concessionary” where investors are willing to concede a market return to meet their impact goals.

Which is best?

Of course, any of these investment styles may be suitable for investors depending on one’s investment objective. Within the muni market, we have observed different styles of each of the above investment strategies across the industry. While ESG/impact investing is a nascent market for municipal bonds, we expect it to grow quickly and have developed an approach we believe meets our investors’ goals and objectives.

Which investment category is the DWS approach for munis?

Integrating ESG risk factors is something that has been a part of our fundamental credit research approach since long before ESG became a widely discussed topic. For example, a core component of our research process for revenue bonds has always been an evaluation of the obligor’s physical location, factoring in exposure to flooding and other natural disasters. Similarly, assessing management’s policies and practices is a longstanding pillar of our analysis for governmental issuers.

With our sustainable investing offering, this same fundamental credit approach continues, with the added step of providing impact-oriented scoring for clients that are interested in investing exclusively in projects with compelling positive attributes. Our approach is, however, not concessionary.

Aren’t all muni bonds ESG?

One could make the case that most bonds issued in the municipal market generally align with ESG principles by virtue of being predominantly issued for the public good, ranging from a voter-approved general obligation bond used to finance public school construction to revenue bonds issued to provide essential services like clean water or reliable electricity. However, when we were developing our methodology it was very important to both us and to the prospective clients that we surveyed that we differentiate the product from our traditional municipal bond offerings with a strategy that integrates ESG factors as well as incorporates an impact focus. Under our methodology, after evaluating a number of municipal bond credits through both inclusionary and exclusionary criteria, our acceptance rate for the ESG/impact strategy has been 30–40% for credits we have evaluated thus far.
So how does DWS approach scoring?

In developing our process, we started out by consulting with a variety of market participants, including diverse stakeholders such as issuers, underwriters, prospective clients, third-party ESG rating firms, and internal subject matter experts at the DWS Office for Responsible Investment. In hosting these listening sessions, it quickly became apparent there was no one-size-fits-all approach and we felt the optimal way to deliver a product that was tailored to our beliefs was to develop it ourselves.

The cornerstone of the process we developed involves evaluating every bond issuance individually because issuers may issue bonds for a variety of purposes – such as undisclosed general capital projects or using proceeds for a more beneficial project that might meet our requirements.

When looking at deals, we first screen to exclude for sin sectors and issuers with coal and/or nuclear exposure above certain thresholds, which we have found eliminates up to 5–10% of the muni market.

Our process then continues by scoring the remainder of the investable universe using a proprietary methodology that individually scores the three ES&G pillars using internally-developed key performance indicators (KPIs). While some investment products focus almost exclusively on environmental impact or social impact, we look at a combination of the two as we strongly feel that doing so is key to allowing us to maintain our meaningful level of selectivity while still providing an appropriate investable universe across diverse sectors. For example, while our ESG portfolios still tend to have a manageable overweight to the water and sewer bond sector relative to traditional portfolios, nonprofit healthcare credits often also score favorably under our methodology, allowing us to leverage our credit expertise in the space and provide exposure to lower credit quality issuers if that is within a client’s risk tolerance.

Even more distinctly, we also look at governance as a co-equal driver of impact, a notable differentiator from most peer offerings. Beyond being an important aspect from a risk mitigation standpoint, good governance can keep communities vibrant and sustainable for the long-term. Incorporating governance allows us to further diversify our universe of approved credits, allowing for leaders in environmental stewardship and the “smart city” movement to be recognized and included.

Now that we’ve shared the basics of our framework, let’s take a deeper dive into some specific KPI examples that we consider under each of the three pillars:

### EXAMPLES OF KEY PERFORMANCE INDICATORS

<table>
<thead>
<tr>
<th>Environmental</th>
<th>Social</th>
<th>Governance</th>
</tr>
</thead>
<tbody>
<tr>
<td>Clean Water</td>
<td>Per Capita Income</td>
<td>Pension Funding</td>
</tr>
<tr>
<td>Renewable Energy</td>
<td>Unemployment Rate</td>
<td>Management Quality</td>
</tr>
<tr>
<td>LEED–certified Construction</td>
<td>Community Impact</td>
<td>Controversies</td>
</tr>
<tr>
<td>Climate Mitigation and Adaptation</td>
<td>Poverty Rate</td>
<td>Continuing Disclosure</td>
</tr>
</tbody>
</table>

- **What is the purpose of the debt issue?**
- **Who does the debt issue support?**
- **Is the issuer a “good municipal citizen”?**

**Environmental**

Projects that score positively for the environmental pillar include water treatment projects, mass transit projects, energy efficiency projects and climate change adaptation and mitigation projects, to name a few. Green bonds, mentioned to in our introduction, are a growing segment of municipal bond issuance that generally align with positive...
scoring under our environmental pillar. That being said, we do our own independent scoring on green bonds as there have been some unfortunate instances where the “green” merits of a financing have been very questionable – known in the market as “greenwashing”.

For the environmental pillar of our methodology, we view negatively sectors that encourage carbon emissions, largely highway bonds, toll road bonds and airport bonds.

Governance

For the governance pillar, factors we look at include the timeliness and transparency of an issuer’s information, their financial policies and how well they adhere to them, and if they are responsibly funding their pensions or if they are unfairly “kicking the can down the road” and passing the liability onto future generations. Lastly, we also give credit to issuers that are leaders in sustainability issues as well as state and local governments that are leading voices on environmental stewardship that both enrich the lives of their own residents and other regions in the U.S.

Where do we go from here?

Despite growing interest in ESG/impact investing, actual investment has, to date, not reflected this enthusiasm. However, with overwhelming interest from Millennials and their growth in the labor market, we expect capital to find its way into the muni market and believe that ESG and impact investing will only continue to grow over the next decade and beyond.

In our view, the vital next step to encourage bridging the gap between stated interest and actual investment is to make strides in quantifying the impact. While third party resources and issuer-reported data remain scantily available to date, our goal is to work towards quantifying the impact of our capital investments so we can provide our clients with reporting on the scope of the issuers’ use of proceeds and whether or not our clients’ capital is truly making an impact. As the impact investing market evolves, we look forward to continuing to collaborate with market participants towards developing common reported metrics for the asset class.

At DWS, our goal is to continue to be an innovator and leader and leverage our long legacy of ESG and sustainable investing by applying our expertise in the muni market to meet client interest. We see this effort as intertwined with our overall aim of helping our clients meet their investment goals in the complex investment landscape of today and the years to come.
Definitions

**Alpha** is a measure of the active return on an investment. An investment’s alpha is the excess return relative to the beta-adjusted market return.

**Environmental, social and governance (ESG)** issues refer to non-financial issues that may affect the sustainability of an investment.

A **green bond** is a bond specifically earmarked to be used for climate and environmental projects. These bonds are typically asset-linked and backed by the issuer’s balance sheet, and are also referred to as climate bonds.

**Millennial** is anyone born between the years 1981 and 1996.

The opinions and forecasts expressed here are those of the contributors listed on the first page, are as of October 2019, and may not actually come to pass. This information is subject to change at any time, based on market and other conditions, and should not be construed as a recommendation of any specific security.

Important risk information

Bond investments are subject to interest-rate and credit risks. When interest rates rise, bond prices generally fall. Credit risk refers to the ability of an issuer to make timely payments of principal and interest. Investments in lower-quality and nonrated securities present greater risk of loss than investments in higher-quality securities. Inverse floaters are derivatives that involve leverage and could magnify gains or losses on tax-free investments.

ESG investment strategy risk. The Underlying ESG methodology, and thus the Funds’ investment strategy, limits the types and number of investment opportunities available to the Funds and, as a result, the Fund may underperform other funds that do not have an ESG focus. The Underlying ESG methodology may result in the Fund investing in securities or industry sectors that underperform the market as a whole or underperform other funds screened for ESG standards.

Investment products: No bank guarantee | Not FDIC insured | May lose value

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