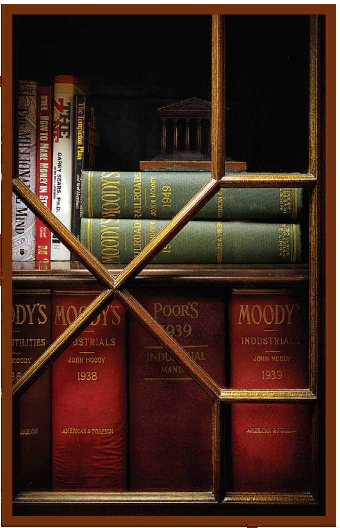
The INVESTMENT LETTER

Volume 90 No. 3 March 2019



Why Care About Social Investing?

We live at a time where a GoFundMe page can unite thousands of strangers in supporting a cause or mitigating a tragedy anywhere worldwide. We live at a time where viral social media posts can influence not just the news, but also current events and those who create them.

We live in a world where investors can band together and influence companies competing for their investment dollars. This happens, increasingly so each year.

While it feel easy and natural for some to join this wave of social investing, what about those who do not believe that values and investing should be combined? Why should they, and all investors, care about social investing?

The answer comes down to market dynamics and simple principles of supply and demand. A 2018 study by Harvard University found that socially responsible investing, or ESG investing, represents some $26 trillion of all assets under management worldwide. That's one-quarter of all assets under management. Those numbers are going to influence the market, and that demand is going to place upward pressure on ESG-compliant security prices. Whether or not you believe in social investing, the market dynamics it drives should be factored into investment decisions.

ESG Investing?

As value-based investing surges in popularity, the practice is still known by other names that have been conjured up along the way, each with their own nuanced meaning. There are the intuitive names: ethical investing, green investing, socially conscious investing. There are the more recognizable: sustainable investing, socially responsible investing. The one that seems to be catching fire is ESG investing, where:

- the E represents Environmental (how the company minimizes its impact on the environment),
- the S represents Social (how the company interacts with its communities), and
- the G represents Governance (how the company runs itself and incentivizes its employees).

An example of each follows:

Environmental: Has the company established reporting regarding their consumption of natural resources? Have they set emissions targets? Energy consumption targets?

Governance: As companies increasingly expand worldwide, do their boards and senior leadership teams have the necessary diversity to understand new markets?

Social: How do companies monitor their exposure to human rights violations, especially in countries with weak labor laws to which they might outsource production?

Socially responsible investors look to influence a corporation's practices through their investments. They look to influence any number of value-based topics, including: environmental practices, consumer protection, human rights, community development, diversity, climate change, health, and safety.

Just How Big Is Big?

In 2018, US Trust found that ESG concerns influenced the investment decisions of High Net Worth (HNW) Investors more than half (53%) of the time. While isolating millennials yields a much higher number, 87%, US Trust found that ESG is still important to both Gen Xers (65%) and women as a whole (64%). Another study, by big-four consulting firm PwC in 2015, discovered that 71% of respondents would decline an investment based on ESG grounds.

Those are important numbers. Here's one more. In a recent paper on ESG investing, EY states that millennials stand to inherit some $30 trillion of wealth in coming years. EY goes on to point out that when assets are passed down to a new generation, firms generally lose 70%-80% of those assets. Tracing the dots, if ESG investing is important to millennials, it is also growing in importance to firms, funds, and other investors.

How Does ESG Investing Work?

Three varieties of ESG investing have developed. The oldest, negative screening, involves an investor eliminating companies as he or she comes across some trait perceived as a negative. This varies, of course, based on the investor's respective value set, but elimination triggers may include a company's environmental performance or commitments to its diversity, or lack thereof, on its board. Another, more inclusive model, involves ESG scores, which are determined based on information that supports or detracts from a company's ESG performance. A certain score threshold means inclusion into a portfolio, while missing the score threshold blacklists the security. The third type of ESG investing, impact investing, represents the most proactive ESG option – actively investing in companies that are actively seeking change.

How to Determine If a Stock Is ESG-Compliant

For years, experts and investors have struggled to create a definition for ESG that resonates with a broad swath of investors, who may not share political, ideological, religious, or social views. The swirling possibilities of definitions have begun to coalesce. Generally, ESG funds exclude securities with ties to weapons manufacturers, tobacco and alcohol, gambling, and any company that commits frequent or significant environmental transgressions. Debate remains, however, over how to create a definition for ESG that can span the many different viewpoints and value systems in a country as diverse as the United States.

Can you invest in your values without giving up returns?

Take any finance class and you will walk away understanding that diversification generally reduces risk and, in a long-term, buy-and-hold strategy, increases returns. But, when you start excluding certain securities or groups of securities from your potential portfolio, you are, in theory, reducing your ability to diversify, and some would argue, reducing return. Right? No so fast.

A 2013 German study, Where and When Does It Pay to be Good? A Global Long-Term Analysis of ESG Investing, examined stocks from around the world with high ESG scores over a five-year period. The researchers found that a buy-and-hold strategy with stocks showing high ESG scores financially outperformed other investing strategies over the long-term by a significant margin, producing "significantly positive abnormal returns up to 20% in North America and Europe."

Conclusion

As ESG investing surges into the mainstream, hurdles certainly remain. The misconception that choosing securities based on values rather than solely on economic merit somehow automatically translates to lower returns must be overcome. Also, all investors, even those who do not "buy into" social investing, must come to realize that its dynamics will influence the performance of securities, and of portfolios, for years to come.

Investors need a solid way to quantify and measure not only the financial returns of their ESG portfolios, but also their "impact returns" as well. Finally, the very definition of what makes a stock ESG-compliant needs to be fully defined. While one set of investors will embrace a certain cause as socially responsible, another may vehemently oppose that cause, or instead prioritize another.

Lastly, like everything in this world, nothing lasts forever. As millennials move into middle age and beyond, they too may follow the path of prior generations, becoming more fiscally conservative and thereby reducing their affinity with, and the popularity of, ESG investing. For now, though, ESG investing remains a topic that is impacting investments, and one that should surely be considered when formulating an investment strategy. ■

Investment Counsel News

Inside the Office

We are exploring opening an additional office in Northern Michigan. There appears to be an opportunity to grow our business with migration of wealth to the beautiful lifestyle Northern Michigan offers.

Outside the Office

After a twenty-year pause, Chris has resumed a hobby from his past, and is enduring the Winter by downhill snow skiing.