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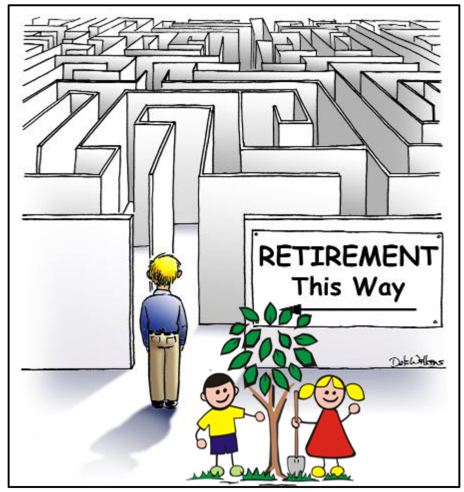
ESG/SRI investing: Many options for "doing good"

"It isn't easy being green."
– Kermit the Frog, TV and movie personality (1955 -)

Navigating the Retirement Maze



I recently completed a project for a non-profit client that was interested in a low-fee portfolio which adhered to that institution's charter for investing. Their criteria included a range of social issues – both negative screens (e.g., no tobacco, weapons, fossil fuels) as well as positive ones (good corporate governance, alternative energy) – but with the desire to still show strong investment performance that would help the institution further their mission. It was an interesting exercise, and one in which I discovered the complexities of so-called "green investing."

I was able to assemble a portfolio that accomplished the stated goals, while significantly reducing the management fees. In the process, I learned that there are many versions and permutations available for socially aware investing, and achieveing total perfection on investment choices is extremely difficult. However, by understanding the available investment options and the screening methodologies, it is possible to develop portfolios that even Henry David Thoreau would be proud to own, had he been into material possessions.

ESG's history

The investment practice that currently goes by the moniker ESG (Environmental, Social, and Governance) is not new. Back in the 18th century, the Methodists were opposed to the slave trade, smuggling, and conspicuous consumption, and were among the first religious institutions to ban investments in sin industries, a policy which continues today. The discipline was first called SRI – Socially Responsible Investing – and has its roots during the 1970s with the calls for divestment of South African stocks. By the 1990s, the list of companies that institutions were being pressured to exclude from their portfolios included those involved in weapons, tobacco, alcohol, nuclear power, and gambling. More recently, the awareness of global warming and its environmental impact has resulted in an added negative filter on fossil fuels, and a positive one for alternative energy sources.

One of the first screens for socially aware investing was the Domini 400 Index. Created in 1990, and rebranded as the MSCI KLD 400 Social Index in 2010, it provided a filtering mechanism for investors who wanted to include social and environmental factors in their choice of investments. Today, a number of institutions perform extensive screening of companies for adherence to various social factors. Reuters and Morgan Stanley have established independent entities to perform this research on an ongoing basis. Morningstar, an investment research firm, began scoring funds on what they refer to as "Sustainability" a year ago, and currently rate over 100 ESG mutual funds.

Is performance sacrificed?

In the 1960s, the Nobel Prize winning economist Milton Friedman opined that adhering to social responsibly criteria adversely affected a firm's financial performance, and on a broader scale this form of "interference" by investors and governments would have an adverse impact on the overall economy. It is safe to say that Dr. Friedman, while a brilliant economist, was quite wrong in this conclusion, at least as judged by the performance of ESG-focused funds. A 2016 report by TIAA Global Asset Management found no statistical difference between ESG funds and the broad market benchmarks, nor did the ESG funds entail any additional investment risk. A year earlier, a Deutche Asset & Wealth Management study showed positive correlations between ESG and corporate performance. Morgan Stanley reached a similar conclusion in their study on ESG bonds released in the same year, and a Barclays study in 2016 concluded that a positive ESG tilt resulted in "… a small but steady performance advaitage." As further evidence, the MSCI KLD 400 Social Index has outperformed the S&P 500 over the past 25 years.

Many definitions

Part of the challenge with ESG investing is determining one's own criteria for what constitutes socially responsible investing, as every organization and ESG fund has their own set of screeening criteria. Wikipedia's description of ESG investing includes a matrix of the various mutual ESG/SRI mutual funds and the screens that each employs for determining appropriate investments. It shows five negative and seven positive screens, and not surprisingly, few funds use the exact same screening methodology. The organizations cited previously that develop filters for public companies have considerable overlap in their scoring, but don't use identical criteria which can result in a particular company or fund receiving a range of scores.

ESG mutual funds and exchange traded funds (ETFs) vary considerably in their definitions of "socially responsible," so it makes sense to do some research into how each fund or fund family does their screening to see whether it matches with your criteria for guilt-free investing. There are funds that use broad criteria, both negative and positive, as well as those that focus in on very specific objectives, like alternative energy, water resources, and gender equality investments.

Options for ESG investing

If you want to simplify your task by selecting a few SRI/ESG mutual funds, there are an ample number of choices available, though most carry considerable management fees that tend to be higher than comparable non-SRI/ESG funds. There are currently over 150 mutual funds that claim some degree of socially responsible asset selection criteria, and management fees range from 0.14 percent to over 2 percent. However, expect increasing competition to drive down fees over time. Major investment firms like Goldman Sachs and Blackrock have recently entered this this category, competing with established ESG managers like Parnasus, Pax World, and Calvert.

ETFs have been particularly active in this segment recently, and more funds that address ESG/SRI or specific niches are appearing regularly. My most recent count showed 45 EFTs in this category, and I expect the number to increase over time.

Socially aware investing tends to be most prevalent among Millenials and women investors, two groups who will likely see their assets increase over the coming years. This provides an added impetus for investment firms to increase their ESG offerings.

Choosing the right funds for a portfolio that matches your ethical and performance objectives can take a bit of work, particularly given the limited track records of many of these funds. You still need to adhere to the usual investment criteria for diversification, cost, and risk management. But having done your homework, you can end up with a set of investments that will allow you to "do good while doing well."

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