Socially Responsible Investing

Aligning Your Portfolio with Your Values

Technological advances over the last few decades have made investing a much more transparent and efficient process for the average investor. However, these same technological advancements have also eroded the relationship between an investor and their investments. Prior to modern technology, investors received a stock certificate that indicated their ownership in a firm. While inefficient and cumbersome, stock certificates were a tangible representation of an investor's equity ownership in a company. Today, stock certificates are no longer necessary due to the advancement of computer systems. While this has made the market more efficient, it has also blurred the line between investors and their ownership in companies. We often forget today that when we invest in a stock, whether it be purchasing the stock directly or by owning a fund which holds the underlying stock, we are thereby partial owners of the company.

In most cases, an investor's goal is to purchase a set of stocks and bonds that best reflect their investment objectives whether that be capital preservation, long-term appreciation, or current income. However, another important consideration for many investors should be whether an investment aligns with their value system. It can be counterproductive when the two do not harmonize. For example, a gun control activist may unknowingly own the stock of a gun manufacturer in their portfolio. It is hard to be a gun control advocate when part of your portfolio is invested in companies that promote gun ownership.

Socially responsible investing (SRI) tries to re-engage the relationship between an investor and their portfolio. The definition of socially responsible investing is different for every investor because everyone has a different value system. Broadly speaking, SRI is an investment strategy which incorporates both the financial returns and the social/environmental impacts of a company or fund. The three central criteria for socially responsible investors are the environmental, social, and governance (ESG) impact of a company:

- **Environmental concerns** examine corporate contributions to climate change (e.g. fossil fuels) and environmental sustainability (e.g. deforestation).
- **Social factors** consider a corporation's inclusion of diversity in its recruiting policies, human rights track records, animal welfare, and consumer protection practices.
- **Governance assessment** examines ownership and control, the quality of the board, executive compensation, employee relations, and remuneration policies.

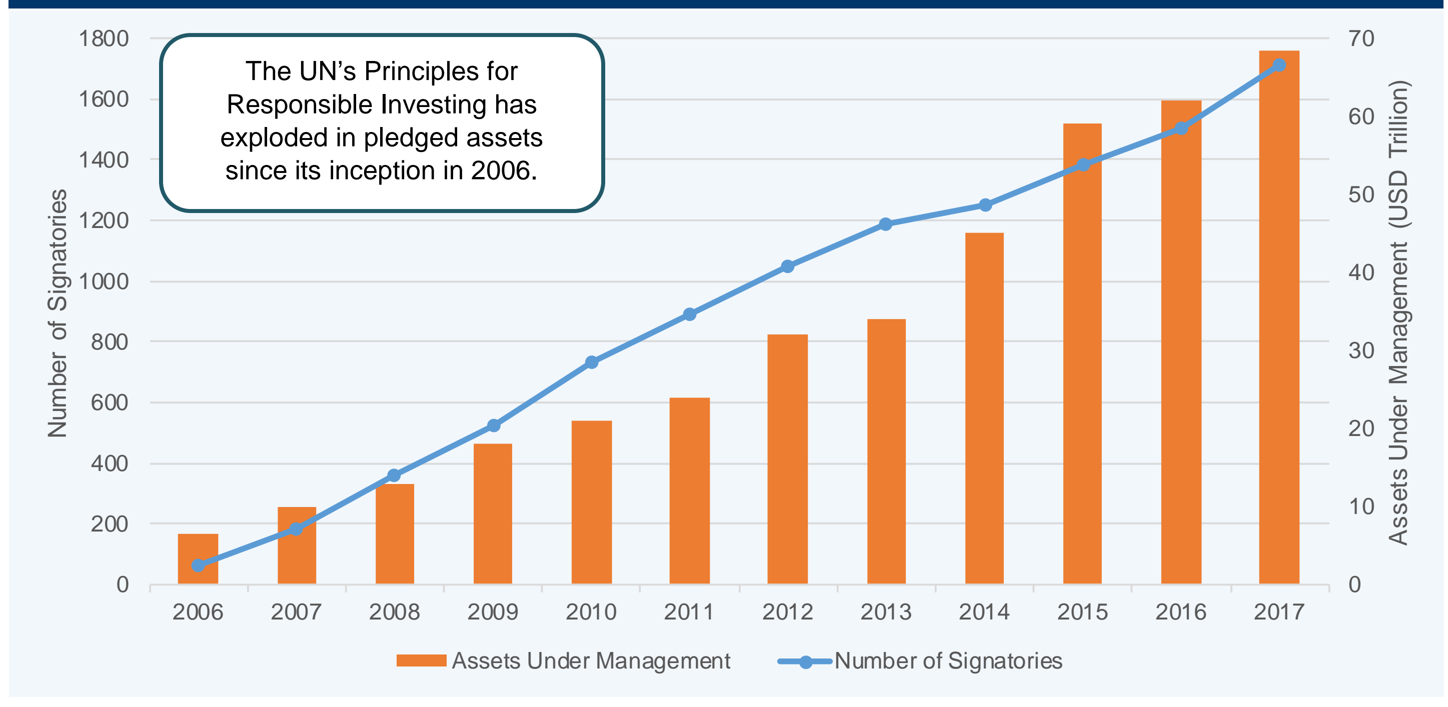
Figure 1: Leading ESG Criteria in 2016

As you can see from the list above, there are many causes championed under the SRI umbrella. While each individual investor will have a different set of socially responsible criteria, the end goal is to align your portfolio with your belief system. By investing in socially responsible companies which reflect your values, you are putting your money where your mouth is – and still earning a return!

The Evolution of Socially Responsible Investing:

Socially responsible investing has a vibrant history in the United States. Back in the 18th century, the Methodists avoided investing in companies that manufactured liquor or tobacco products while the Quakers prohibited members from investing in the slave trade. In 1928, a group from Boston launched the Pioneer Fund, which was the first publicly offered socially responsible fund. The fund applied screens to eliminate "sin" industries such as alcohol, tobacco, and gambling and is still in business today. Socially responsible investing gained steamed during the Vietnam War when activists urged public endowment funds to stop investing in defense contractors. Progress continued in the 1980s when socially responsible funds were noted for their efforts to end the racist system of apartheid in South Africa. By 1990, there was sufficient demand to begin scoring companies based on their performance in certain ESG categories. In 2005, the United Nations launched the Principles for Responsible Investment which created a set of guidelines for its signatories to follow when investing. As of 2017, the Principles had over 1,750 signatories representing almost $70 trillion in assets.

Figure 2: Growth of United Nation's Principles for Responsible Investing



Over the last few years, socially responsible investing has exploded in growth as investor demand has grown. From 2012 to 2016, socially responsible assets in the US more than doubled from $3.7 trillion to $8.7 trillion and according to the US Forum for Sustainable and Responsible Investment, more than one out of every five dollars under professional management in the United States today is involved in socially responsible investing. One reason why the growth of SRI has been so robust is that research has shown that investors do not have sacrifice returns to invest in a socially conscious manner. In fact, some studies have shown that the opposite might be true.

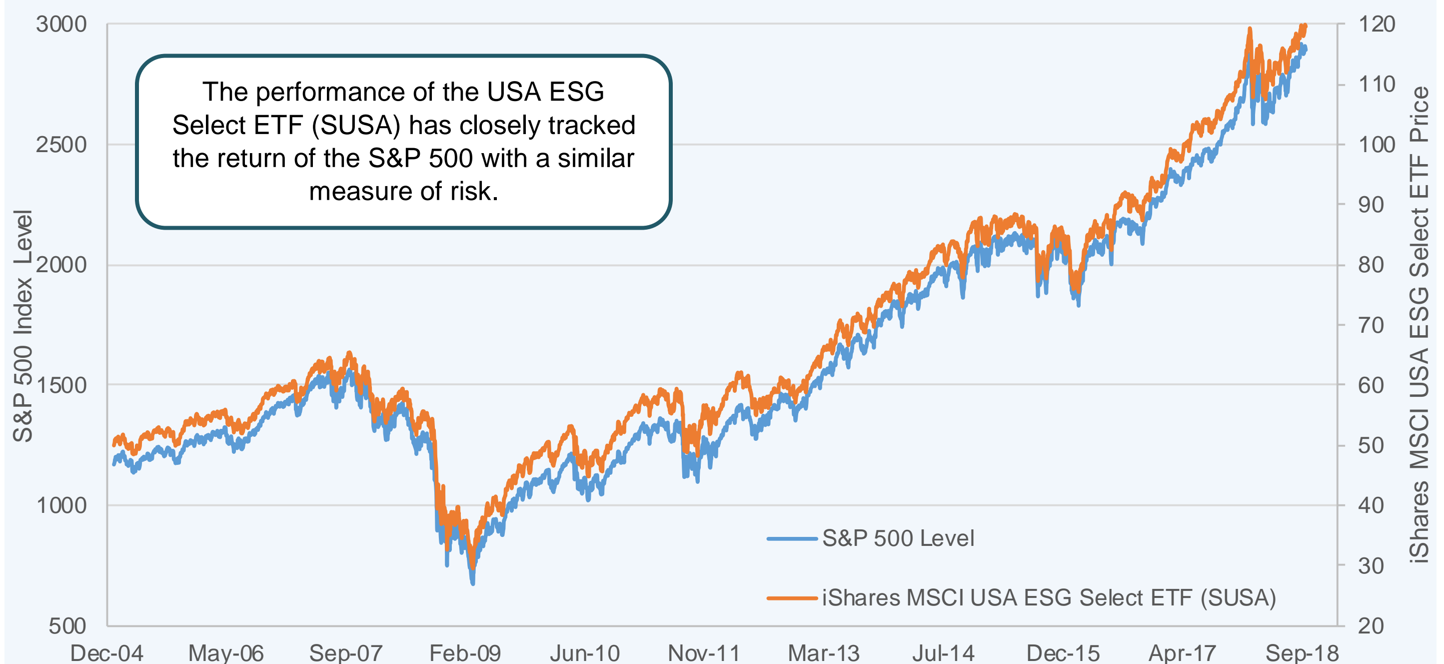
No Need to Sacrifice Returns for the Greater Good:

A common misperception among investors is that incorporating ESG factors into a portfolio can hurt performance. However, numerous studies have shown evidence that companies who score strongly on various ESG factors actually outperform the market over the medium and long term. Listed below are the results from some large studies over the last few years:

- A 2015 meta-study by Oxford University and Arabesque Partners, reported that "88% of reviewed sources found that companies with robust sustainability practices demonstrate better operational performance, which ultimately translates into cash flows.
- A 2015 meta-study by Deutsche Asset & Wealth Management and Hamburg University found that 90% of studies find a nonnegative relationship between ESG scores and corporate financial performance. More importantly, this positive relationship appeared to be stable over time.
- A 2014 study by MSCI found a statistically significant relationship between a more diverse leadership and better financial performance. The companies in the top quartile of gender diversity were 15% more likely to have financial returns that were above their national industry median."
- A 2015 study by MSCI concluded that "companies with strong female leadership generated a return on equity (ROE) of 10.1% per year versus 7.4% for those without."

While the results of these studies are encouraging, there still needs to be more research on the subject. Most of these studies look back only a decade or two, which in the financial world is a short time period to determine whether the results are a short term correlation or a longer-term trend.

Figure 3: Comparative Performance of MSCI USA ESG ETF (SUSA) vs S&P 500 Index



Not only have studies shown that there appears to be a positive relationship between high ESG scores and individual stock performance, but past performance of SRI funds have shown that they can replicate the performance of an asset class with similar levels of volatility. For example, the chart below shows the performance of the iShares MSCI USA ESG Select ETF (SUSA) vs the S&P 500 since January 2005 (which was the fund's inception). As you can see, an investor who invested in SUSA would have experienced a very similar return profile to an investor who picked the S&P 500.

There are Many Ways to Incorporate SRI into a Portfolio:

While socially responsible investing has a different meaning for each investor, there are some common practices to incorporate SRI into a portfolio. The three main strategies are negative screening (also known as exclusion), positive screening, and impact investing.

Negative Screening –The process of negative screening is the strategy that most people associate with SRI. A negative screen means excluding specific companies from a portfolio if they don't meet the investor's standards. The practice of negative screens has been around for centuries. For example, the Quakers in the 18th century refused to invest in the slave trade. Today, popular negative screens are for companies that sell tobacco products, alcohol, or weapons. While negative screening is the most widespread form of socially responsible investing, it is not always the most effective one. All it does is simply transfer ownership from an unhappy investor to a more willing one. It does not make an active attempt to inspire corporate changes.

Positive Screening – Positive screening is the flip side of the coin. Instead of excluding companies that don't match certain criteria, positive screening purposefully includes companies that perform well in a particular ESG category. This is usually done through a scoring system which then incorporates stocks that perform best in a certain category. The best-in-class approach has its shortfalls as well. For instance, this strategy tends to favor companies with a larger market capitalization because they have more resources than smaller companies to institute socially responsible initiatives. These initiatives then translate to higher SRI scores which in turn attracts more assets from SRI funds which then steers more capital to larger companies.

Impact Investing – Unlike screening, impact investing is an active approach to SRI. An impact investment requires an intention to generate a measurable social or environmental impact. Screening merely includes or excludes companies based on their past ESG results or industry. It is impossible to measure the social benefit from you deciding to include or exclude the stock from your portfolio. Impact investing, on the other hand, should have a measurable social return in addition to the financial return to the investor. While impact investing may have a greater end result, it may require a larger effort to identify investment opportunities that fit your investment profile as well as your belief system profile.

Figure 4: Strategies to Incorporate SRI into a Portfolio

Avoids Exposure → Targets Outcome

	Negative Screening	Positive Screening	Impact Investing
Definition	Excluding companies or funds from a portfolio if they are not compatible with investor's value system	Incorporating companies or funds into a portfolio based on their positive ESG policies and practices	Investing in companies or organizations with the intention to generate a measurable social or environmental impact
Example	Not investing in companies that generate a significant portion of their revenue from the sale of weapons	Overweight a portfolio to companies that have higher ESG scores	Investing in a low income housing unit
Pro	Can successfully avoid investing in industries/stocks that are not aligned with your belief system	Can achieve a more diversified portfolio than negative screening or impact investing	Has the ability to measure a direct social/environmental return on your investment
Con	Does not inspire corporate changes. Avoiding an industry, will not make it go away	Can include companies or industries that may not align with your beliefs	Typically are less liquid investments that can have considerable risks

Aligning Your Value System with Your Portfolio:

The biggest drawback to socially responsible investing is that there is no perfect way to completely align your portfolio using just one of the three options listed above. Negative screening will devoid your portfolio of certain industries and investment opportunities, positive screening will include companies that you may not consider to be socially responsible, and impact investing can be hard to replicate into a fully diversified portfolio. At Miracle Mile, we realize that no SRI solution is perfect, especially because every client will have a different definition of socially responsible. Therefore, our solution attempts not to create an ultimate SRI portfolio, but instead, aims to meaningfully improve the overall ESG rating of a portfolio without sacrificing diversification.

Our socially responsible model involves vetting SRI focused ETFs and mutual funds within each asset class of the portfolio. The funds are chosen not just on their ESG scores, but also on their past performance, expense, as well as risk analytics. We understand that each fund has a different set of SRI criteria which may result in conflicting viewpoints. For example, one fund may include Microsoft while another may exclude it. The goal isn't to reconcile the different views among the funds, but instead raise the overall ESG score of the portfolio. While this process is not perfect, our SRI model portfolio does achieve a 10% higher ESG score than our non-SRI models based on Morningstar's Sustainalytics Scoring System. While this system is not for everyone, it is a step towards helping our clients align their portfolio with their values.

Important Disclosures:

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Figure 1: Leading ESG Criteria in 2016: Shows the top five categories for ESG incorporation by money managers in 2016. Conflict risk defined as exclusion of companies doing business in countries with repressive regimes or that sponsor terrorism. Board issues includes matters such as director's independence, diversity, pay and responsiveness to shareholders. Source – The US Forum for Sustainable and Responsible Investment 2016 Trends Report.

Figure 2: Growth of United Nation's Principles for Responsible Investing: Shows the number of signatories of the UN's PRI Initiative from 2006 to 2017 in the blue dotted line. Source – United Nations Principles for Responsible Investing

Figure 3: Comparative Performance of US ESG ETF (SUSA) vs S&P 500 Index: Shows the index level of the S&P 500 (left axis) and the price level of the MSCI USA ESG ETF (SUSA) (right axis) from Jan 25th 2006 to Sep 17th 2018. Over the time period, the S&P 500 rose 146.6% vs the MSCI USA ESG ETF (SUSA) which was +139.7%. Source – ycharts.

Figure 4: Strategies to Incorporate SRI into a Portfolio: Defines three different techniques to incorporating socially responsible investing into a portfolio.