Responsible Investing: Creating Financial and Non-Financial Value
By Gregory D. Wait
November, 2014

Responsible Investing is a growing discipline used by professional investment managers that incorporates Environmental, Social and Governance (ESG) criteria in the process of security selection. Historically referred to as "Socially Responsible Investing," this approach has been around for decades; however, the question persists: do investors sacrifice returns in pursuit of their goal of advocating for a better world in which to live?

Generally, in a capitalist economy, corporate governance is driven by incentive systems and monitors with a goal of creating wealth for shareholders. For publicly-traded companies, with potentially thousands of owners of stock in the corporation, shareholder interests are represented by a board of directors to whom management reports. This approach has worked over the years to create dynamic economies in the United States and in many countries around the world that have embraced free-market concepts. Government regulations have been put in place to promote fair trade and to penalize corporate corruption and other actions that shake investor confidence.

Some corporations are broadening the concept of governance to a "stakeholder" view, by which sustainable economic wealth is generated by creating positive relationships with a variety of groups that have legitimate interests in the organization. These companies and their managers strive to be responsible for reasonable and fair treatment of their primary stakeholders (stockholders, employees, customers, suppliers, and creditors) as well as their secondary stakeholders (community, environment, society, government, and competitors), all of which are affected by decisions they make. While the U.S. has been relatively slow to adopt this philosophy, other countries around the world believe that large corporations have a social responsibility that is greater than solely maximizing stockholder wealth.

To be sure, the management of companies that subscribe to the stakeholder view is challenging and, to some extent, controversial. While it is fairly easy to measure the success of organizations that seek solely to maximize shareholder wealth (price of the company's stock), it is more challenging to measure the progress of corporations that seek the responsible treatment of a diverse group of stakeholders. It is common to have manager incentives line up with maximizing shareholder value via stock options and other stock ownership programs. Incentivizing management for success in serving stakeholders is far more complicated. Still, more corporations are coming to the conclusion that they do share broader social responsibility and that sustainable economic wealth can follow such behavior.

For example, Mondelez International Inc., a spin-off of Kraft Foods and the maker of Oreo cookies, recently addressed the challenges they (and other food producers) face due to climate change by designing programs to help cocoa farmers in Africa and other countries develop sustainable ways of producing their crop. Over recent years, there has been a dramatic change in the availability of the raw materials needed to make Oreo cookies, as well as increased volatility in the price of these ingredients. To quote Irene Rosenfeld, CEO of Mondelez: "We've made a $400 million investment for the next 10 years to help cocoa farmers in a number of ways. One is to help them improve their yields. We've been able to teach them different methods of farming, which help them to improve their yields by up to 20%. We've been working to help them improve their salaries by up to 200%, because in many of these cocoa-farming villages, many of the young people leave the farm because they can't see their way to making a sustainable income." Mondelez has also worked with farming communities in Africa, Vietnam, and Indonesia to help them set up infrastructures that will lead to more sustainable production of cocoa or coffee crops.

American Express operates in 160 countries and lists the following company values:

- We develop relationships that make a positive difference in our customers' lives.
- We provide outstanding products and unsurpassed services that, together, deliver premium value to our customers.
- We uphold the highest standards of integrity in all of our actions.
- We work together, across boundaries, to meet the needs of our customers and to help the company win.
- We value our people, encourage their development and reward their performance.
- We are good citizens in the communities in which we live and work.
- We exhibit a strong will to win in the marketplace and in every aspect of our business.
- We are personally accountable for delivering on our commitments.

It is interesting that only three of these company values can be directly related to revenues or profits of the organization. Another well-established U.S. corporation, Target, donates 5% of profits to local communities, strongly encourages their team members to volunteer their time to local service organizations, and establishes corporate responsibility goals in the areas of education, sustainability, team member well-being and volunteerism.

Clearly, companies like Mondelez, American Express, and Target believe that their corporate responsibilities extend beyond maximizing shareholder wealth. In the long-run, organizations that embrace the stakeholder theory of corporate governance believe they will generate sustainable shareholder value.

There is a growing trend among investors, individually and institutionally, to invest in companies that share their values about the environment, social responsibility and corporate governance…and to promote positive change. In recent years, activist shareholders' top priorities include board diversity, executive pay, transparency on political contributions, increased disclosures on activities that effect the environment, and human rights improvements. Large pension and endowment funds often include ESG criteria when selecting securities for their portfolios and understand the influence they may have regarding these issues. The professional investment management industry has capitalized on investors' desires by creating socially responsible mutual funds. Today, more than 11% of all money under professional management, representing over $3.74 trillion in assets, is invested with ESG strategies, an increase of 22% since 2009. Over 1,000 institutions worldwide have now signed on to the Principles for Responsible Investment (PRI), as supported by the United Nations.

Individuals who desire to invest according to their values typically seek mutual funds that use various ESG criteria, and there are a growing number of such funds available in the marketplace. According to our research, *Morningstar* currently recognizes 71 U.S. stock mutual funds as "socially conscious" and 42 of these funds now have a track record of over ten years. Some of the longest-tenured stock mutual funds are based on Christian values and morals, and many have used an exclusionary approach to security selection. For example, some funds "negatively screen" stocks and will not invest in companies that are involved with abortion or pornography, manufacture alcohol or tobacco products, or do business in countries that are known to violate basic human rights.

In recent years, mutual fund managers have focused on using screens to develop a list of companies that are "ESG leaders" by considering their impact on the environment and society, as well as how they are governed. This list of companies becomes the investable universe for these funds, and portfolio managers then can select securities from this universe that otherwise meet their specific investment criteria. Investment professionals have found that companies that excel at managing their ESG responsibilities are often the best managed companies operationally and may have competitive advantages relative to their peers. So, by utilizing positive screen methodologies, rather than an exclusionary approach, professional investment managers have a broad range of securities to choose from and their selection criteria can be very transparent, industry-specific, rigorous and consistent.

Because some of the oldest ESG investment strategies utilized the exclusionary approach, there is a common perception that investors must sacrifice returns in order to adhere to their values. The thinking is that, because the universe of potential securities is limited, the return potential is also limited. We sought to test this hypothesis and compared the returns (multiple time periods ending 9/30/2014) of socially conscious mutual funds relative to non-socially conscious indices and peer groups in the following U.S. stock style categories: Large Cap Blend, Large Cap Value, Large Cap Growth, Mid Cap Blend/Value, Mid Cap Growth, Small Cap Blend/Value, and Small Cap Growth. In addition, we analyzed the returns in other investment categories, including World Stock, Foreign Large Cap Blend, and Intermediate-Term Bonds. To summarize our analysis:

- Among all mutual funds categorized by *Morningstar* as socially conscious (174), 7 are rated 5-Star, 30 are 4-Star, 56 are 3-Star, 44 are 2-Star, 20 are 1-Star, and 17 are not rated due to having a track record of less than three years. *Morningstar* star ratings are assigned based on risk-adjusted returns relative to other funds in the category, with 5-Stars being considered the best. So, 59% of rated funds are considered 3-Star or better.
- Across the U.S. stock mutual fund categories (71 funds), the average ESG fund ranked at the 51st percentile over the past one-year period, the 49th percentile over the past three-year period, and the 42nd percentile over the past five-year period. So, generally these funds ranked at or better than the median fund in the respective category.
- U.S. Large Cap Blend Funds: 56% generated returns in excess of a standard benchmark (S&P 500 Index) over the past ten-year period; 41% beat their benchmark over the past seven-year period; and 32% beat the benchmark over the past five-year period.
- U.S. Large Cap Growth Funds: 38% delivered excess returns over the past ten-year period; 56% had excess returns over the past seven-year period; and 31% generated excess returns over the past five-year period.
- Foreign Large Cap Blend Funds: 38% exceeded a standard benchmark (MSCI EAFE Index) over the past seven-year period; 33% generated excess returns over the past three and five-year periods.
- Intermediate-Term Bond Funds: 75% produced returns in excess of a standard benchmark (Barclays Intermediate Government/Credit Index) over the past ten-year period; 45% had excess returns over the past five-year period; and 58% delivered excess returns over the past three-year period.
- Other fund categories had smaller sample sizes, but generally exhibited results similar to those described above.
- On a risk/return scatterplot, measuring returns vs. standard deviation (volatility) of returns, socially conscious mutual funds tend to plot around the median of all funds in their respective categories.

This analysis demonstrates that the performance of ESG mutual funds is generally consistent with the performance of broad actively-managed strategies. As with the selection process of any actively-managed mutual fund, investors must evaluate the consistency of the investment process, commitment and tenure of investment personnel, management of the parent company, and fees associated with each fund prior to making an investment in an ESG mutual fund. With a disciplined selection approach, individuals can invest in ESG funds that should deliver performance in line with other actively-managed mutual funds, with a similar chance of outperforming market indexes over time.

While the earliest socially-responsible funds were primarily invested in U.S. Large Cap Stocks, ESG funds have become available in a wide range of investment categories, as illustrated in our analysis. An equity investment provides general capital to a publicly-traded company; however, as the ESG industry has expanded, it has become apparent that fixed income investments can be solutions-oriented. For example, bonds can be issued to support specific projects such as renewable energy, clean water, community and economic development, or affordable housing. Therefore, an investor who is interested in professionally-managed ESG funds can now build a diversified portfolio of stocks and bonds that is appropriate for his/her time horizon and risk tolerance.

In summary, good corporate governance benefits shareholders, and it is becoming apparent that a broader stakeholder approach to corporate management can provide sustainable economic wealth for shareholders as well as communities and societies. We've concluded that investors with a desire to utilize environmental, social or governance criteria are likely to realize outcomes similar to those who do not screen for such factors. ESG investing may offer investors the "double bottom line" that many are seeking – competitive returns with the opportunity to align their portfolios with their values.

Gregory D. Wait, CEBS *is President of Falcons Rock Investment Counsel, LLC, an independent investment consulting firm located in Germantown, Wisconsin.*

Endnotes:
This research was conducted using the *Morningstar* mutual fund database and the Informa/PSN analytical system. Other sources of information include:

- *Corporate Governance (2nd Edition)* – Kenneth Kim, John R. Nofsinger, Derek J. Mohr
- TIAA-CREF Asset Management
- *The Wall Street Journal*
- Principles for Responsible Investment – www.unpri.org
- *Morningstar Advisor*
- *Fortune Magazine*
- AmericanExpress.com
- Target.com