Capitalism Is Evolving

By Gina Chironis, CPA; Brooke Salvini, CPA; & Robert Ades, CPA

What it Means to You & Your Clients

Investment managers in the U.S. and around the globe have been shifting their attention from investing purely for profits. Professionally managed dollars are increasingly invested to support client-driven concerns around the environment, social issues and corporate governance—commonly referred to as ESG investing (Figure 1).

According to the U.S. Sustainable Investment Forum's 2020 Trend Report (ussif.org/trends), at the end of 2020, 33 percent of the $51 trillion in professionally managed investments in the U.S. were managed with ESG issues in mind. In Europe, the percentage was even higher at 50 percent. Even more notable is the rapidly accelerating rate of adoption: a 43 percent increase in values driven investing since 2018.

FIGURE 1

Top Specific ESG Criteria for Money Managers 2020

Source: US SIF Foundation

You and your clients are likely impacted by this accelerating trend through mutual or exchange-traded fund investments, even those without specific ESG objectives, as more professional managers incorporate ESG data into their overall due diligence.

ESG Defined

How are these various issues defined by investment managers? Major environmental considerations include efficiencies in the production of goods and use of natural resources, pollution reduction and legal risk reduction. Climate change issues around carbon emissions and sustainable natural resources captured more than $6 trillion in 2020. Social considerations center more on labor and human rights issues, and governance issues focus on appropriate behavior by corporate executives and board members around independence, diversity and compensation.

There are several investment approaches included in this trend. The most common is ESG, which emphasizes values without impacting profits. Sustainable Investing was defined in 1987 by the United Nations in Our Common Future as "Development that meets the needs of the present without compromising the ability of future generations to meet their own needs."

Socially Responsible Investing (SRI) and Impact Investing are also popular and tend to prioritize social outcomes over investment returns.

A helpful framework for thinking about these varied approaches is seen in Figure 2 from Vert Asset Management (vertasset.com), a mutual fund manager focused on investing globally in sustainable real estate.

The Triple Bottom Line

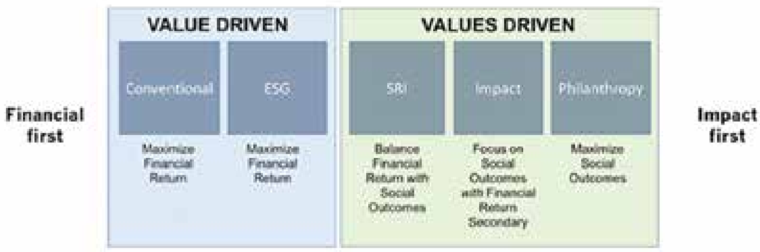
The common thread in the shift toward ESG, SRI, Sustainable and Impact investing is an attempt to set goals for and hold corporations accountable to a triple bottom line (TBL), a concept introduced by John Elkington in the 1990s that examines both the negative and positive social and environmental impacts of corporations along with profits.

According to *The Economist*, the TBL "aims to measure the financial, social and environmental performance of the corporation over a period of time. Only a company that produces a TBL is taking account of the full cost involved in doing business."

Since its introduction in the 1990s the concept has been applied by corporations to produce TBL reports but, in Elkington's June 2018 article in the *Harvard Business Review*, he states that the "success or failure on sustainability goals cannot be measured only in terms of profit and loss. It must also be measured in terms of the wellbeing of billions of people and the health of our planet, and the sustainability sector's record in moving the needle on those goals has been decidedly mixed. While there have been successes, our climate, water resources, oceans, forests, soils and biodiversity are all increasingly threatened. It is time to either step up—or to get out of the way."

FIGURE 2

Defining Sustainable Investing



Source: Vert Asset Management

ESG is Environmental, Social, and Governance
SRI is Socially Responsible Investing

"While there have been successes, our climate, water resources, oceans, forests, soils and biodiversity are all increasingly threatened. It is time to either step up—or to get out of the way."

Given the accelerating shift in how investment dollars are managed today, it seems many investors and professional investment managers may agree. The question is: Are corporations paying attention, in Elkington's words, to their "people and planet targets"?

The short answer is yes!

Measuring ESG

With all the attention ESG is receiving in the investment community it's natural to wonder whether the financial reporting around these metrics is accurate and reliable.

The voluntary disclosure of financially material ESG data has increased, along with the market demand for this information in recent years. While standardization of ESG measures and benchmarks around the globe is still not a reality, there has been significant progress. The five major ESG reporting organizations (CDP, CDSB, GRI, IIRC and SASB) issued a Statement of Intent to Work Together Towards Comprehensive Corporate Reporting in November 2020.

An emerging leader and participant in the alliance guiding disclosure and benchmarking is the Sustainability Accounting Standards Board (SASB, sasb.org). The world's largest public accounting firms are involved in the SASB effort, which has market support for SASB standards as a core component of corporate disclosures.

The SASB is a nonprofit that published 77 global, industry-specific standards identifying financially material sustainability topics and their associated metrics for the typical company in an industry in 2018.

According to the SASB, "In today's economy, sustainability issues are global business issues that impact the financial condition, operating performance, and enterprise value of companies. Data security—a social issue—is important to companies in the software industry. Water management—an environmental issue—is essential to a beverage producer. Managing conflicts of interest—a governance issue—is critical for an investment bank. Effectively managing these issues over the long-term is likely to improve business performance in the form of reduced operating costs, enhanced reputation, greater resilience to risks, the potential for competitive advantage, and drive long-term enterprise value."

Motivations

While performance is always on the minds of investors, there are numerous reasons to engage in sustainable investing beyond just the annual return.

Individuals may have a desire to incorporate their personal values and goals in the investment decision. Doing so fosters essential, societal and environmental benefits in the public sector that are not as easily achieved by government policy decisions alone. Examples might include support for companies that are positive stewards of the environment, employ good labor practices, or foster diversity and social balance in corporate governance. For institutions, sustainable investing may be an outgrowth of their mission or a requirement for their fiduciary duty.

Investors often believe that sustainable investing comes at a cost, either in reduced returns, increased risk or both. While investors can undoubtedly choose investment vehicles that focus on specific causes at the expense of risk and return, there are plenty of opportunities to achieve close parity with conventional investments. Recently, data has supported similar, if not higher, historical outperformance of ESG portfolios over their non-ESG counterparts.

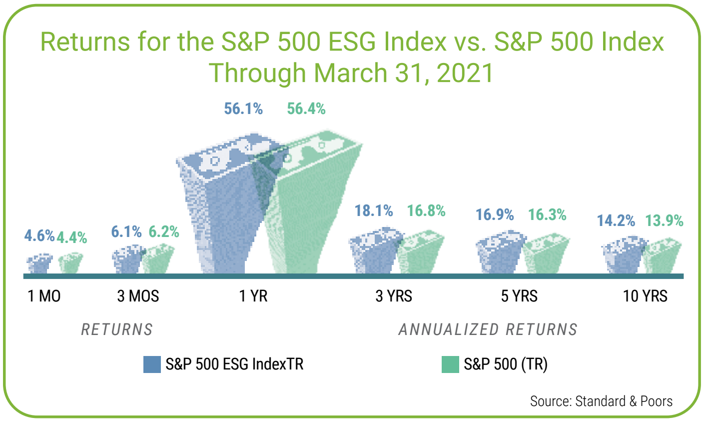
To illustrate, the S&P 500 ESG index was designed to promote an ESG mandate for U.S. large cap stocks while providing a risk and return profile similar to the S&P 500 Index. For the 10 years through March 31, 2021, the ESG index delivered an annualized total return of 14.2 percent against 13.9 percent for the non-ESG counterpart. Further, the S&P 500 ESG index outperformed the S&P 500 Index in most of the periods shown in Figure 3.

While these data are of limited duration and cannot be construed as forward-looking, many investment professionals believe that ESG investing may provide higher future returns as consumers and government policy-makers increasingly favor companies employing these practices.

One aspect of ESG investing is the ability to control certain types of risk. A portfolio focused on ESG metrics may have better resilience to future challenges that could impact non-ESG investments.

For example, there may be regulatory changes that negatively impact companies' earnings more reliant on fossil fuels or excessive use of natural resources compared to those that make better use of renewable energy.

FIGURE 3



Sustainable investing also provides a framework to measure risks not normally captured in traditional GAAP measures.

For example, a shoe manufacturer that consumes twice as much water as its competitors may have higher utility costs, which may be a minor factor in overall performance and EPS data. However, ESG will additionally consider the risks associated with rising water costs or the potential impact of a water shortage. These factors may highlight avoidable risks by focusing on sustainability.

Strategies & Tactics

ESG can be embraced at various levels of commitment. For many investors, starting small for example by allocating only a portion of their investments to index mutual funds with an ESG objective is the best way to test the waters. Many mutual fund companies including Vanguard, Dimensional Funds and Blackrock offer well-diversified low-cost funds that evaluate holdings for ESG criteria or otherwise utilize ESG in formulating investment decisions. If an investor wants to increase commitment to ESG there are many opportunities.

Before making an investment decision, thought should be given to specific ESG goals, interests and passions. As noted earlier in the article, climate change, diversity and social justice, or avoidance of specific issues or industries are common impact investing objectives. Each one of these or a combination can be incorporated into an investment strategy implemented through mutual or exchange-traded funds.

Investors with high enthusiasm and commitment to ESG can choose more targeted funds that meet many specific criteria such as a Global Clean Energy Fund or a Women Leadership Fund. Fully committed ESG investors may be interested in selecting individual companies based on industry metrics available through one of the ESG reporting organizations mentioned above, such as the SASB or Morningstar, the investment research firm, which provides sustainability ratings for many companies in their database.

Ownership of individual company stock gives an investor access to proxy voting and shareholder activism—two powerful tactics available to express ESG concerns. In addition, several mutual fund companies are taking a more proactive stance on proxy voting and shareholder activism at the request of the investors in their ESG funds.

ESG is not just for investing in equities. The same ESG criteria can be applied to fixed income. The universe of ESG bond funds has been expanding quickly. In addition, it is possible to invest in what are called Green Bonds. The proceeds from these debt issuances are used specifically to combat the challenges of climate change such as improving or building necessary infrastructure.

And finally, some of your clients may be interested in very targeted impact investing through direct micro-lending. A couple examples include the non-profits Root Capital and the UNICEF USA Bridge Fund or Lending Club.

Final Thoughts

Values-based investing in support of environmental, social issues and corporate governance has greatly evolved over the last five years. We now have standards, metrics, data and analytics that were not available just a few short years ago. Perceptions about cost versus potential return that might have been accurate in the past need to be evaluated and updated. Similar to the introduction of index funds, exchange-traded funds, asset-based fees rather than commissions and other investment industry trends, ESG, which was previously considered the fringe, has likely reached the tipping point into the mainstream of investing. CPA

Gina Chironis, CPA/PFS is the founder of Clarity Wealth Management, Inc. **Brooke Salvini, CPA/PFS, CFP** is the owner of Salvini Financial Planning. **Robert Ades, CPA, CFA** is the founder of Robert Ades Accountancy Corp and Ades Investment Counsel, Inc. You can reach them at gina@claritywealth.net, brooke@salvinifinancial.com and ra@robertades.com.

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Useful Resources

The Forum for Sustainable and Responsible Investment
ussif.org

Social Funds
socialfunds.com

Vanguard ESG, SRI, Impact Investing: A Primer for Decision Making
personal.vanguard.com/pdf/ISGESG.pdf

Morningstar ESG Investing
morningstar.com/company/esg-investing

Green Money Journal
greenmoney.com

Micro-lending
kiva.org