Milwaukee Journal Sentinel
JSOnline.com

*Sunday,
January 2, 2022*

BUSINESS

Investors must be cautious and smart shoppers when considering 'ESG' investments

SPECIAL TO THE JOURNAL SENTINEL
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One of the most talked about trends in the asset management industry is Environmental, Social, and Governance or "ESG" investing.

ESG investing spilled over into the retirement plan industry recently when the Department of Labor proposed a rule encouraging retirement plan sponsors to incorporate ESG criteria when selecting investment alternatives and voting company proxy statements.

Although ESG investing is a relatively new and often confusing topic, the debate over how best to allocate investable capital, for profit or for good, has been with us for a long time.

What is ESG Investing?

Historically, investing for good was known as "socially responsible" investing, and focused on restricting investment into industries deemed harmful to society such as tobacco, fire arms, gambling, and nuclear power. ESG investing employs a broader definition of what it means to invest for good.

The "E" represents a focus on companies with environmentally friendly business models and involves obtaining data measuring a company's carbon foot-print, policies concerning water pollution, and anything else linked to "climate-related" financial risk. The "S" pertains to matters of social concern such as work place diversity, employee turnover, labor relations and community involvement. The "G" focuses on matters of corporate governance such as executive compensation policies, and diversity on the board of directors.

How can you participate?

The first challenge of investing for good is deciding what that means to you. After all, doing good with your financial resources is an extremely subjective undertaking. Religious-based (i.e. Catholic or Islamic) and impact-based (i.e. climate, diversity, equality) investment strategies abound. The vast majority of these strategies are focused on picking the right stocks to own, but there are bond and balanced ESG strategies as well.

The least expensive, and often the best, approach to access ESG strategies is with an index fund. The most closely followed ESG index is probably the Dow Jones Sustainability World Index. Two of the most heavily invested indexes are the MSCI USA ESG Leaders Index and the FTSE4Good US Select Index. All securities included in these indexes are carefully screened for a variety of ESG criteria including workplace conditions, environmental impact, product safety, human rights, and corporate responsibility.

Is ESG a better way to invest?

The performance of ESG strategies relative to the broad market is mixed, both in practice and within the academic literature. Practically, ESG strategies focused on large-cap growth stocks like Microsoft, Alphabet, and Amazon have generated substantial returns for investors recently. All three companies routinely score quite favorably in ESG metrics.

Because of the heavy weighting in large-cap technology, the aforementioned index products have also shown competitive results versus the S&P 500 within the last 3-years. It's important to ask, did these companies and portfolios outperform specifically because of ESG policies or for other reasons? It's hard to tell. Given that the industry is still deciding what ESG is and what ESG isn't, ardent proponents of ESG claiming performance superiority at this stage in the game look premature.

ESG strategies, by definition, limit investable opportunities based on criteria not related to their profitability. Historically, strategies not focused on a company's bottom line, have experienced opportunity costs. For instance, April 2020 through mid-December 2021, but the S&P Oil & Gas sector returned more than 90%, but companies in this sector are significantly under-invested by most ESG strategies. During this same period, most ESG index returns averaged closer to a 50% gain.

One very large bond manager has gone on record predicting the expected return for its ESG bond fund is 30 basis points lower per year versus its comparable flagship bond product which doesn't have an explicit ESG mandate. Perhaps the return differential won't change your decision, and that's your prerogative, yet the risk/reward tradeoff of ESG is important to consider in your analysis.

Buyer Beware

The asset management industry is keenly aware of the growing customer interest in ESG. The amount of ESG product coming available is multiplying rapidly. While an ESG-themed strategy may align with your worldview and public policy preferences, feeling good about making an investment has the potential to turn off critical thinking.

Be advised there are numerous instances of underperforming funds relabeling themselves an ESG product. This attempt to reboot sales is so common, the industry now has a name for it - "greenwashing." Just because the investment manager puts 'ESG' or some other kind of friendly sounding ESG-moniker into the name of their fund, doesn't mean it's likely to accomplish your objectives.

Looking Forward

ESG investment strategies should receive the same scrutiny and vigorous due diligence as any other strategy that you'd consider no matter how passionately you feel about a cause. Do the homework to make sure the ESG product you're considering aligns with your beliefs, is managed by a skilled manager, and you understand the potential opportunity costs.

Based on the growing interest from investors and attention it's getting in company board rooms around the globe, ESG strategies are here to stay.

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