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Socially Responsible Investing for Families

Investing for reasons other than pure risk-adjusted returns has grown very rapidly in recent years. That activity goes by many names: socially responsible investing (SRI), ESG (Environmental, Social and Governance) investing, impact investing, ethical investing, mission-related investing, and so on. (See the appendix to this paper for definitions of each type of investing.)

- → The term 'ESG' was first coined in 2005 in a landmark study called 'Who Cares Wins'
- → In 2018, over 80% of the world's largest corporations use Global Reporting Initiative (GRI)[1] standards
- → ESG investing is estimated at over $20 trillion in AUM

Source: The Remarkable Rise of ESG, Forbes, July 11, 2018.

The vast majority of the capital engaged in socially responsible investing is institutional in nature: sovereign wealth funds, large pension plans and endowments, universities, private foundations. But families have gotten into the act, too, and sometimes in a very big way.

Responsible investing is especially popular among younger family members – often referred to as "Next Gen." Millennials, for example, overwhelmingly see responsible investing as a way to carry out their social agendas (64%), compared to 42% for Baby Boomers.

Source: ESG Investor Sentiment Study from Allianz Life Insurance Company.

Very often, though, Next Gen family members who want to adopt socially responsible investing approaches find themselves wholly or partly thwarted by skeptical family members, by trustees subject to fiduciary responsibility, and even by the sheer complexity of the responsible investing field.

In this white paper we focus on the dynamics of initiating a discussion on the topic by

[1] The Global Reporting Initiative (GRI) is an international independent standards organization that helps businesses, governments and other organizations understand and communicate their impacts on issues as climate change, human rights and corruption.

presenting a "typical" family dialogue in an effort to provide families a heads up about some important considerations in introducing socially responsible investment principles into their investment portfolios. We also hope to suggest approaches that might allow both enthusiastic and skeptical family members to find common ground.

For purposes of this paper we are assuming that the family has gathered at a regular investment committee meeting. The players are as follows:

Dad (G2, a responsible investing skeptic)

Mom (G2, another responsible investing skeptic, but also a peacemaker)

Deb (G3, enthusiastic proponent of responsible investing)

Kyle (G3, also enthusiastic, but maybe less of a true believer)

Stephanie (non-family member representing the family's corporate trustee, she is nervous about potential liability if social investments underperform)

Jack (non-family member, long-time financial advisor to the family and focused on helping the family make good investment decisions (responsible investing-related and otherwise))

Setting: the family is assembled around a conference table at the office of the corporate trustee. All four family members are present, along with Stephanie and Jack.

Jack: If everyone is ready, why don't we start through the agen...

Deb: Excuse me, Jack, but I want to say something. I was reading through our family value statement last night. We worked on that for months a few years ago, as I'm sure everyone will recall. Anyway, it seems to me that we try to live by those values in every aspect of our lives *except* in our investment activities. Why is that?

[Awkward silence around the table, finally broken by Kyle.]

Kyle: I wonder the same thing. Why don't we invest with the same values we live by? Is there some reason for it?

Dad: Well, yes, there *is* a reason. Ever since your grandfather sold the family company years ago we have invested with one goal in mind – to achieve the maximum possible return consistent with our tolerance for risk.

Mom: In fact, Deb and Kyle, that goal was written into our investment policy statement by your grandfather and it's been there ever since. The idea is to earn as much as we can and then to spend that money in ways that are consistent with our family's values.

Dad: In other words, we live modestly considering our resources. We have our own personal charitable programs and we also have the family foundation's program. The more we earn on the portfolio, the more we have to give away to make the world a better place.

Deb: I remember Grandpa very well, Dad. He was a hard man, but a fair and honest man. If he had to do something unethical to make a sale, he just wouldn't do it. He wasn't trying to make the most money he could make, he was trying to run an honest business.

Dad: Wait a minute, Deb, are you suggesting that we are being dishonest in how we invest…

Kyle: No, that's not what Deb means, Dad. She's saying that Grandpa wouldn't violate his own principles just to make more money, and neither should we.

[Dad starts to speak, but Mom shoots him a look.]

Mom: Jack, you work with a lot of families like ours. How do they handle this issue?

Jack: Each family is different in how they approach the issue of socially responsible investing. Frankly, people are all over the map when it comes to grappling with this topic. Our advisory firm's approach has been to help them define – as a family – what they want to accomplish related to socially responsible investing as part of their overall investment program.

Deb: But some families are doing it, right? And I'll bet they're doing pretty well, too. I've read some studies that say you can invest responsibly and not reduce your returns.

Jack: Actually, Deb, I would be a little careful with some of those studies. Most of them were done by money managers who have a vested interest in selling you a socially responsible investment product. Instead, I would focus on the academic research, which is more objective.

Kyle: And what does that research say?

Jack: This is a very broad generalization, but what it says is that, if you are very careful and have an investment process and thesis, you can invest responsibly and potentially not harm your returns. There are different ways to integrate socially responsible investing.

[Laughter.]

Mom: Can you be more specific, Jack? What does it mean to "be careful?"

ACADEMIC RESEARCH

Jack discusses the academic research that suggests social issues that are relevant to a company's business can actually improve returns. For example, if water quality is crucial to your product – Coke or Pepsi, say – then a company that pays little attention to water quality is probably a bad long-term investment. This important component of socially responsible investing is known as "materiality." He specifically cites research done by Professor George Serafeim at Harvard.[2]

On the other hand, Jack points out that just because an investor really believes in the importance of some social behavior or other, that doesn't mean that the market cares about it or that it will have any effect on a company's stock price. Some ESG factors are important and some aren't, and some are important to some companies but not others.

Deb: Well, okay, I guess I understand that. But there are corporations doing things I don't like, and I simply don't want to own them. Is there something wrong with that?

Jack: It depends, Deb. Let's say that you don't want to own coal mining companies. You can probably eliminate those stocks from your portfolio and it will have little effect on your returns.

Stephanie: Jack is referring to what we call "tracking error," which measures how differently your portfolio performs against a reference portfolio.

Kyle: Huh?

Jack: [Laughing.] Stephanie and I talk like that so everyone will think we're smart. But here's a simple example. Let's say your current stock portfolio has a "tracking error" of 1% against the MSCI All Country World Index, that is, "ACWI". That means that if the ACWI is up 9%, your return is very likely to be between 8% and 10%. If you eliminated coal stocks, your tracking error would hardly budge.

Kyle: Oh, I see where you're headed with this. If Deb were to say she doesn't want to own any company involved in hydrocarbons at all…

Deb: I was just about to say exactly that!

Kyle: I knew it! But where Jack is going is this: where do you draw the line? Isn't that right, Jack?

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[2] Mozaffar Khan, George Serafeim and Aaron Yoon, "Corporate Sustainability: First Evidence on Materiality," *Accounting Review* 91, no.6 (November 2016).

Jack: That's exactly right. It's important to define to what degree you are going to express your desire not to own coal stocks. Not owning coal mining companies is one thing. But what about oil companies? Gas companies? Utility companies who have coal-fired power plants? Auto companies whose vehicles run on gasoline or diesel? Companies that make parts for any of these companies?

Stephanie: In other words, if you really, really don't want anything to do with hydrocarbons, you will end up with a very weird portfolio that could seriously underperform.

Jack: And, not incidentally, make your corporate trustee very uncomfortable!

Dad: That's an important issue. Steph, where does the bank stand on socially responsible investing?

Stephanie: I wish I could give you a simple answer, but, well, it's complicated.

FIDUCIARY ISSUES

For the next few minutes Stephanie describes the struggles of her trust department to reconcile beneficiaries' interests in social investing with the bank's fiduciary responsibilities. She mentions that one of the best current guides to fiduciary duties and social investing is a paper written by Max Schanzenbach and Robert Sitkoff.[3]

Stephanie: The core problem has to do with the duty of loyalty. As a trustee, we are required to act purely in the interests of the beneficiaries of the trust. So, just to take an extreme example, suppose the bank decided that it felt strongly about hydrocarbons and didn't want to own any company that used them. Ten years go by and the trust performs very poorly against, say, the S&P 500 Index. The beneficiaries could sue us for breaching our duty of loyalty. We invested according to our own values, not according to the interests of the beneficiaries.

Dad: And, as I understand it, Stephanie and her bank must consider *all* of the beneficiaries. That includes your Mom and me, as well as any children you and Kyle might have in the future. If the bank took the direction Stephanie just described, I would not be happy!

Kyle: But, Steph, are you saying that the bank wouldn't permit *any* socially responsible investing?

[3] Max M. Schanzenbach and Robert H. Sitkoff, "Reconciling Fiduciary Duty and Social Conscience: The Law and Economics of ESG Investing by a Trustee," forthcoming in Stanford Law Review, Vol. 72 (2020).

Stephanie: No. A few years ago, that might have been true, but we've come a long way since then. Let me show you where we are quite comfortable, where we might be able to get comfortable, and where we probably *couldn't* get comfortable.

Stephanie outlines the bank's attitude toward socially responsible investing as follows:

- → Negative screens. The bank is willing to adjust portfolios by removing unwanted companies so long as the resulting tracking error of the portfolio remains within a reasonable range.
- → ESG-oriented funds. Many managers offer portfolios designed to focus on companies that are environmentally friendly, that have positive attitudes toward social issues (inclusiveness, community-awareness), and that follow best governance practices. If these funds have competitive track records, the bank is willing to invest in them.
- → Impact investing. Some funds are designed to achieve a "double bottom line," that is, to make a competitive return but also have a positive impact on the world in one way or another. The bank is willing to consider such funds, but its focus will be on the "competitive return" angle, not the "impact" angle. In other words, a fund that has a large positive impact but a lousy return would be an unacceptable investment.

Deb: So, you're saying that the bank, as our trustee, *is* willing to do some socially responsible investing. Perfect! Let's get started!

Dad: Whoa, hold on there! As I understand it, there are a lot of issues with socially responsible investing that need to be considered. Isn't that right, Jack?

Jack: Yes, there are, although careful investors can avoid them.

AVOIDING THE PITFALLS ASSOCIATED WITH RESPONSIBLE INVESTING

Jack outlines the main pitfalls responsible investors need to avoid:

- → ***Greenwashing.*** Because socially responsible investing has become increasingly popular, the sales oriented financial industry has jumped into the sector with both feet. Some of the products are good, but many are simply ordinary investment products that have had a "green" label slapped on them merely to increase their appeal. If investors truly believe in the social issue they are pursuing, they will need to look carefully under the hood and make sure the fund they are looking at actually "walks the walk".

- *Beware of the financial industry in general.* Financial firms are notorious for taking advantage of investors, and socially responsible investors are no exception. If a story about the advantages of an impact fund seem too good to be true, it probably is. As an example, the Abraaj healthcare fund was launched to acquire and build hospitals in undeveloped nations, simultaneously bringing health care to remote regions and building valuable assets. Exactly why it was that Abraaj would succeed where others had failed was never clear, and in 2018 it all collapsed. The top three executives, including the director of impact investing, have been arrested and charged with fraud, and the fund itself is being dissolved.

- *Good intentions don't count.* There are lots of areas of human endeavor where good intentions matter a lot, but socially responsible investing isn't one of them. In this area, good intentions, if not married to serious diligence, can make the world not a better place, but a much worse place. Jack mentions the example of the switch to biofuels, which was hyped as a means of removing vast amounts of carbon from the air. Instead, huge swaths of forests were cut down to plant corn in order to feed the biofuels appetite, resulting in the release of so much carbon into the atmosphere that scientists concluded it would take a century for the benefits of ethanol to overcome the initial carbon explosion and finally begin to reduce carbon emissions.

Dad: That's a lot of pitfalls, Jack!

Jack: True, but there are pitfalls in every kind of investing. The bottom line is, just as in every other area of investing, you need to take your diligence seriously.

A WAY FORWARD

Mom: How about this? Suppose we start by picking an issue that's important to Deb and Kyle and agree that we won't own companies that are engaged directly in that line of business? In other words, we might eliminate coal mining companies, but not all hydrocarbons.

Dad: Agreed. And we won't eliminate secondary companies that, for example, use coal as a fuel. Utility stocks for example.

Deb: It sounds like we're chickening out.

Kyle: Yes, we probably are chickening out, big sister. But we have to start somewhere, and if this works, we can take a bigger step sometime in the future. What do you say?

Deb: Could we at least be on the look-out for interesting investments in the socially responsible area that might have good track records?

[Everyone exchanges looks.]

Mom: That would be fine with me.

Kyle: And me.

Dad: Well, I guess I'm outvoted. Jack, I assume your firm can sort through all the socially responsible options and bring us only the best of them to consider?

Jack: Yes, we have increasingly interesting investments in the socially responsible sector (in both equities and bonds), and we'll be happy to share our findings with you.

Stephanie: And the bank itself is in the process of developing some socially responsible investment funds, at the request of our clients. If you don't mind, we'll run those by Jack's firm as well. The initial funds will be passive ESG index funds, but we're also looking at some actively-managed opportunities in the impact space.

Mom: Well, how about that!? We just talked through a very sensitive issue and no one – well, no one except Dad – even raised his voice. Maybe we should all hold hands and sing Kumbaya!

Deb, Kyle and Dad: Pass!

This paper was written by Kristi Combs, Managing Director, and Gregory Curtis, Chairman and Managing Director, of Greycourt & Co, Inc. Please note that this presentation is intended to provide interested persons with insights on the capital markets and is not intended to promote any manager or firm, nor does it intend to advertise their performance. All opinions expressed are those of Greycourt & Co., Inc. The information in this report is not intended to address the needs of any particular investor.

APPENDIX: DEFINITIONS[4]

There are many definitions used in the marketplace for Environmental, Social and Governance (ESG) incorporation, socially responsible investing, sustainable investing and impact investing. Below is an excerpt from a publication from the US SIF Foundation, which undertakes research and educational activities in the sustainable and responsible investing space, which should be helpful for readers striving to understand some of the differences (keeping in mind that different people define these terms in different ways). The US SIF Foundation defines sustainable, responsible and impact investing (broadly known as SRI) as an investment discipline that considers ESG criteria to generate long-term competitive financial returns and positive societal impact. For more information, readers can visit ussif.org/sribasics.

ESG incorporation is the consideration of environmental, social and corporate governance criteria in investment analysis and portfolio construction across a range of asset classes.

ESG incorporation can be accomplished in numerous ways:

- **Positive/best-in-class:** Investment in sectors, companies or projects selected for positive ESG performance relative to industry peers.
- **Negative/exclusionary screening:** The exclusion from a fund or plan of certain sectors or companies based on specific ESG criteria.
- **ESG integration:** The systematic and explicit inclusion by investment managers of ESG factors into financial analysis.
- **Impact investing:** Targeted investments, often in private markets, aimed at solving social or environmental problems.
- **Sustainability themed investing:** The selection of assets specifically related to sustainability in single or multi-themed funds.

Investor engagement is the other principal approach for SRI investors. It involves the actions sustainable investors take as shareowners to communicate their concerns to the management of portfolio companies about the companies' ESG policies and to ask management to study these issues, disclose more information about them and make improvements. Investors can

[4] "Incorporating Sustainable, Responsible and Impact Investing Into Your Practice – A Roadmap for Financial Advisors," US SIF Foundation, 2018.

communicate directly with corporate management or through investor networks. For owners of shares in publicly traded companies, engagement can take the form of filing or co-filing shareholder resolutions on ESG issues and conscientiously voting their shares on ESG issues that are raised at the companies' annual meetings.

APPENDIX: ADDITIONAL RESOURCES

- **McKinsey & Company | From 'why' to 'why not': Sustainable investing as the new normal, October 2017**

https://www.mckinsey.com/industries/private-equity-and-principal-investors/our-insights/from-why-to-why-not-sustainable-investing-as-the-new-normal

- **GIIN (Global Impact Investing Network) | Resources for impact investors**

https://thegiin.org/

- **Wharton Social Impact | Research and Reports**

https://socialimpact.wharton.upenn/edu/

- **Administrative Science Quarterly | The Rise of Socially Responsible Investment Funds: The Paradoxical Role of the Financial Logic (Yan, Ferraro, Almondoz), April 2018**

https://journals.sagepub.com/doi/full/10.1177/0001839218773324

- **Tideline | The Alpha in Impact: How operating with an impact objective can add value for investors, December 2018**

https://tideline.com/the-alpha-in-impact-white-paper

- **MSCI | Definitions and resources for ESG Investing**

https://www.msci.com/esg-investing

- **The Purpose of Capital | a book by Jed Emerson, strategic advisor to families and wealth managers on impact investing**

https://www.purposeofcapital.org/get-the-book/