MILLEN CAPITAL

Balancing your values with practical reality

Summary

Most of us are increasingly aware of the social and environmental impacts of our daily lives; we may recycle, avoid buying products from certain companies and try to cut our carbon footprint. In reality though, we make compromises. How does this work when it comes to our portfolio investments? What are the challenges and options for those to whom these issues matter? This note provides a framework for thinking about and dealing with these issues.

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'Nobody is suggesting a return to the Stone Age, but we do need to slow down and look at reality in a different way, to appropriate the positive and sustainable progress which has been made, but also to recover the values and great goals swept away by our unrestrained delusions of grandeur'

Pope Francis, June 2015

The challenges facing our world

In his recent papal encyclical, which he addressed to '*every person living on this planet*', the Pope made a damning criticism of the damage that humankind has done to the planet and issued a plea to change toward a more sustainable future based on stronger values and a respect for the environment. You don't have to be a religious person to take his words seriously.

There is no doubt that since the industrial revolution in the West in the eighteenth and nineteenth centuries, with its pollution, unbridled capitalism and social division, through to the current industrial and technical revolution in China and other emerging economies, we, as a species, have done immeasurable harm to the planet and each other. We face some immense challenges and risks that we can't ignore. They are broad ranging in scope, probability and likely impact, and include things like energy price volatility, mass migration, the IS terrorist threat, nuclear proliferation, biodiversity loss, climate change, water and food scarcity, sweatshops and indentured labour. The challenges can be illustrated by a few, simple, yet alarming facts:

- in China, if you are a one-in-a-million person, there are 1,360 other people like you;
- the top 28% of India's population by IQ is greater than the whole population of North America;
- 150 million babies will be born this year, which is over twice the number of people in the UK today (64 million);
- by 2050 the world will have an additional 2 billion people, totalling 9 billion, looking to sustain themselves and improve the way they live with the same finite resources;
- in as little as 15 years, the demand for food, water and energy will rise by 35%, 40% and 50% respectively[1]

The enormity of these challenges can lead people to question whether, as an individual, they can make any sort of difference. Many people do try in their own small way - carefully recycling waste, buying a more fuel efficient car, putting solar panels on the house – and that is all good. But in the end, the practicalities of modern life get in the way. We want to clothe our children in good value clothes, take a long-haul flight on an Airbus A380 to Australia, or own an iPhone, perhaps oblivious or simply resigned to the impact of our actions on both resources and people. It is almost impossible to gauge what positive impact we are truly making, although doing something is better than doing nothing. At least we try.

Making a difference through investment choices

Despite many peoples' domestic attempts to '*do their bit*', few seem to consider how their investing – that is to say the allocation of their capital – can make a difference. Fortunately, things are changing in this respect. It is estimated, for example, that today $1 out of every $6 under professional management in the US (around $6.6 trillion) incorporates socially responsible investing strategies.

Socially responsible investing - or SRI - is a catch-all term for investment strategies that focus on social or sustainability issues. Social issues broadly relate to issues such as diversity, human rights, consumer protection and animal welfare. Sustainability issues relate to building towards a sustainable use of resources for the world going forwards, and tackling environmental concerns such as climate change and hazardous waste management.

1 Institute for Sustainable Investing (2014), The Business Case for Sustainable Investing, April 28, 2015

There is a further sub-set of nomenclature that most will at least have heard of such as: green, ethical, eco, long-horizon, impact, and values-based investing, to name a few. It can all be a bit confusing. However, in this note, we provide a simple framework for how we can think about SRI investment opportunities.

There is one unifying theme in socially responsible investing today which is that it is an investment discipline that takes into account the environmental, social and corporate governance criteria of companies around the world when investing money, with the aim of generating strong, long-term financial returns, whilst delivering a positive societal impact. These criteria have been abbreviated in the industry to 'ESG'.

Figure 1: ESG criteria underpin SRI investing

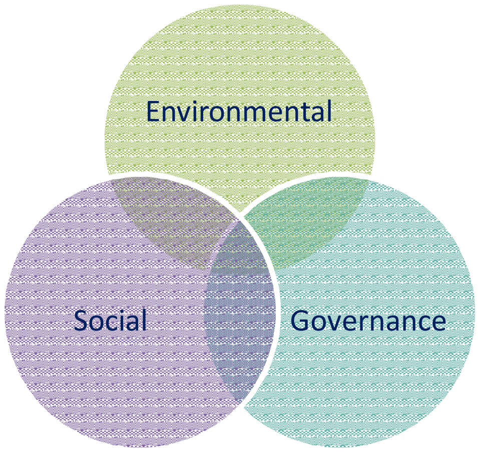

Figure note – examples of ESG issues:

Environmental issues: biodiversity loss, greenhouse gas emissions, energy efficiency, renewable energy, resource depletion (including fresh water), ocean acidification, ozone depletion, etc.

Social issues: mass migration, wealth distribution, access to healthcare, workplace health and safety, diversity, employment rights, child labour, slavery and indenture, controversial weapons such as cluster bombs, etc.

Governance issues: executive compensation, bribery and corruption, independent directors, ethics in business, transparent disclosure of ESG criteria, whistle-blowing policies, stakeholder relations and the implications of business strategy on social and sustainability issues.

SRI is not new

Despite the growing focus on sustainability and social issues, SRI investing, in all its guises, is not new. Long-standing examples are the Quakers and supporters of the abolition of slavery, who boycotted firms involved in slavery. During the industrial revolution and beyond, not all capitalists were outright exploiters of the means of production i.e. their workers. Take, for example, Port Sunlight, a whole town built for the workers of the Lever Brothers' soap factory in the Wirral in the late nineteenth and early twentieth centuries. Over 800 houses and civil amenities were built and the brothers delivered social welfare programmes including education, entertainment and recreation. In more recent history, Barclays Bank and other institutions were boycotted over, and ultimately divested themselves of, investments in apartheid-era South Africa, due to the pressure applied on them. Today, SRI investing seeks to make a difference by taking a firm's ESG criteria into account in the allocation of capital.

A potted history of SRI investing

In the early stages of this new wave of SRI investing, investment opportunities were often described as '*ethical*' funds that avoided the key '*six sins*': tobacco, alcohol, arms manufacturing, pornography, nuclear weapons and gambling. Over time, other opportunities arose to allocate capital in a way that reflected an investor's personal values through funds that screened out other '*bad*' companies and/or industries (from the perspective of the values espoused by the fund), or funds that only invested in '*good*' companies.

This somewhat binary approach has the danger of resulting in unusually structured portfolios, potentially risking capital market returns, or at least being unable to gauge the risks, expected returns and correlations between different investments, which are integral to sensible portfolio construction. It is also very difficult to define '*good*' and '*bad*' in the grey world of commerce. Should a large engineering company with a small subsidiary manufacturing machine tools that could be used in manufacturing arms be classified as a '*bad*' company? The difficulties of such an approach are self-evident.

An alternative approach was to invest without SRI considerations and capture global market returns from a traditional portfolio and use some of the proceeds to fund philanthropic endeavours. However, over the past few years, there has been a growing realisation that donating to charities is not as efficient (after the charities costs have been deducted) or as effective as more direct programmes.

The rise of impact investing – that is to say investments made directly in support of projects such as the building of fresh water bore holes or helping impoverished communities to build small businesses via small direct loans (micro-finance) – has become a viable alternative. As someone wise once said: '*it is better to teach a man to fish and help him to buy a rod, than to give him a fish*'. The Big Issue is a great example of a social impact business, helping to get the homeless back into mainstream society. Other impact projects would be things like renewable energy funds and other environmental (or social) thematic funds.

A more recent development has been the construction of what have become known as '*best-in-class*' SRI investments which do not make binary choices, but over-weight companies relative to their market capitalisation based on positive ESG criteria, or under-weight them if their criteria are poor. The implication is that firms who have better ESG credentials should outperform those that do not, in the long run.

A simple framework for thinking about SRI investing

So, how can investors sensibly integrate SRI investing into their own investment programmes? This simple framework – set out in Figure 2 - may help.

Imagine a continuum with traditional investments at one end and philanthropy at the other. That was the traditional choice. In the middle, now sits impact investing. As you can see, on the left-hand side the driver is financial returns and on the right-hand it is values-based actions, such as charitable donations. The outcomes are also very different: traditional investments seek a return on capital, i.e. a market rate of return for market risks assumed. Philanthropists seek self-actualisation, sweetened by tax relief. The middle ground of impact investing seeks a return of capital, hopefully with some additional return – perhaps to be reinvested in more impact opportunities – but where the financial outcome is less easily defined in terms of expected returns, risk and relationship to other assets held. A continuum of product opportunities exist too, dependent on the strategy adopted, which will range from a more market return oriented approach to less certain characteristics and outcomes of impact projects, such as clean water or renewable energy sources.

Figure 2: A simple framework for making sense of SRI choices

Category	Investing	Impact	Philanthropy
Driver	Financial return	Direct involvement	Values
Financial outcome	Market returns and characteristics	Return of capital plus	Tax relief
Strategy choice	= traditional investments (e.g. global equities) = SRI best-in-class (e.g. global equities) = SRI negative screening = SRI positive screening	= SRI thematic	= donations
Asset allocation (hypothetical)	A blend of traditional and SRI	Specific issues that are important to you	Charities that are important to you

Source: Albion Strategic Consulting[2]

For investors who feel strongly about sustainability and/or social issues, it probably makes good sense to incorporate a '*best-in-class*', diversified SRI fund(s) into a traditional portfolio, accepting that not all asset classes lend themselves easily to SRI investing. On top of that, additional non-core allocations can be made to important issues and causes that are closely aligned with an investor's firmly held values. By-and-large it makes sense to steer away from a binary shopping list of activities/companies/sectors/countries that do not fit an idealist view of the world. The latter

2 Adapted from a diagram produced by Dimensional Fund Managers: Understanding Sustainable Investing, 10th May 2013, Slide 10.

approach is likely to make the structuring of a sensible portfolio extremely difficult both from a portfolio construction process (poor diversification, low market capitalisation, skewed sector weights) and an implementation perspective (too many binary choices that leave very little to choose from in terms of available products).

Taking the long-term view

SRI investing takes a long-term view and is a juxtaposed to Milton Friedman's view that behaving in an ethical way in business would come at a cost. Most people today would accept that companies that score highly on ESG criteria are likely to do better than companies that do not, in the long run. At present the empirical research is somewhat sketchy, but that will grow over time. Less ESG favourable firms will either have to catch up, thereby improving the broader returns of the market, or fail. Each individual investor who invests in an SRI fund is allocating capital towards better firms and away from worse firms from an ESG perspective.

In the long run, as the impetus continues and the incorporation of ESG criteria into company analysis and stock selection decisions becomes mainstream, investors in passively managed index funds will participate in this reallocation of capital as the market capitalisation of favoured companies will rise relative to other less favoured companies with less sustainable strategies. In the shorter-term, passive investors can participate in the process of reallocation of capital through investment in passively managed SRI funds. Costs are likely to be a slightly higher than non-SRI funds on account of the additional work to capture, assess and rank the ESG criteria of firms. For some, this may be a price worth paying.

Conclusion

Just as we have to make trade-offs between cutting our carbon footprint and the family's holiday trip to Australia aboard the Airbus 380, we have to do so in our investment programmes too. In an ideal world it would be wonderful to invest only in specific projects and investments close to one's individual values, such as renewable energy schemes or micro-finance projects, but practical reality forces us to find a balance between capturing the market returns we need to meet our own personal goals and being true to our values. The latest generation of best-in-class SRI funds may help to find a compromise that is a step in the right direction for some.

Other notes and risk warnings

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