The Challenge of Socially Responsible Investing

Surprisingly, the Trump administration has been a boon for environmental and socially conscious stocks. But that doesn’t mean this strategy is a slam dunk.

BY TAYLOR TEPPER

CONVENTIONAL WISDOM said Donald Trump would spell doom for companies that emphasize environmental, socially responsible, and governance (ESG) issues. Yet since he took office this year, ESG stocks have actually pulled ahead of the broad market.

Not only that, socially responsible investing (SRI) funds—which seek to use investment dollars to bring about change on issues ranging from global warming to equal pay—have already attracted more new money in the first four months of this year than in all of 2015. And they’re on track to exceed last year’s haul of more than $6 billion, according to Morningstar.

Are investors holding out hope that Trump—who seeks to slash the Environmental Protection Agency’s budget by nearly a third and who recently pulled the
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SOCially RESPONSIBLE INVEStING

United States out of the Paris climate agreement—has a soft spot for socially responsible causes?

Hardly.

Some of the gains made by ESG stocks can simply be chalked up to a political reaction.

"You are making a statement by where you invest," says Andrei Cherny, chief executive of online bank Aspiration, which runs Aspiration Redwood, the top-performing ESG fund over the past 12 months. "The growth of socially responsible and sustainable investing is part of a long-term trend we've seen over the past decade, but is even more important in the Trump era."

In addition to that, though, investors may be embracing another long-standing tradition on Wall Street: contrarianism. To be a successful investor, you have to be willing to go against the grain, even if it seems crazy to do so.

Eight years ago, for instance, conventional wisdom said that President Obama's views on gun control would threaten the fortunes of firearms manufacturers. Meanwhile, many investors feared that Obama's push for the Affordable Care Act was going to weigh on the performance of health care stocks.

Yet had you bet on the maker of Smith & Wesson pistols and rifles (a company now known as American Outdoor Brands), you'd have seen your money grow sevenfold. And the health care sector wound up being one of the best-performing parts of the domestic stock market for much of the Obama years.

Well, this same type of counterintuitive opportunity is presenting itself again—this time, with socially responsible investing funds.

To be a true contrarian investor, though, you not only have to give this strategy a chance under Trump's presidency, you have to approach these stocks and funds with a skeptical eye. That's because socially responsible investing is not as simple as it sounds.

DON'T BE FOOLed BY THE PR

Long before the Trump administration, ESG stocks had been growing in acceptance, especially because of their appeal to younger investors. Surveys, for instance, show that the vast majority of wealthy millennials invest in—or are interested in adopting—socially responsible strategies in their portfolios.

In fact, three-quarters of millennials believe that the social and environmental impact of companies should be an important factor in their investment decisions, according to a recent U.S. Trust study.

Helping to propel this view: long-standing arguments made by ESG proponents claiming this strategy—which is also referred to as "impact investing"—produces market-beating results.

In reality, socially responsible investing doesn't always outperform. In fact, since 1994 a broad index of ESG equities produced virtually the same results as the S&P 500 index.

UNDERSTAND THE LIMITATIONS OF THIS STRATEGY

There are a plethora of exchange-traded funds that focus on socially responsible stocks to choose from. And more and more funds are being churned out, including those that go beyond just the environment.

The asset management firm State Street Global Advisors, for instance, recently launched a gender-diversity-themed fund investing in large U.S.
companies "that rank among the highest in their sector in terms of gender diversity within their senior leadership position."

The quest to promote social policy through your portfolio is a noble one, to be sure. If you care about global warming, why not abstain from Exxon Mobil? Shouldn't those opposed to addictive tobacco usage ignore $186 billion cigarette manufacturer Philip Morris International?

Well, it's not quite that simple. For instance, Minnesota is suing 3M, the maker of Scotch tape and Post-it notes, for allegedly having polluted the state's waters. And China Labor Watch, a Chinese workers advocacy group, released a report in the fall of 2015 documenting what it believes to be poor working conditions in a Shanghai factory that manufactures iPhones for Apple.

What do 3M and Apple have in common? They are both held by the iShares MSCI USA ESG Select fund. (Apple officials did not respond to requests for comment. 3M lead counsel William A. Brewer III said, "3M acted responsibly at all times and, of course, will defend its record of corporate stewardship.")

The fact is, while ESG represents a set of guidelines, corporations of all stripes err at one time or another. Or while succeeding on one front, such as sustainability, ESG stocks may fal on another—for instance, by failing to promote women to the C-suite or board.

**PAY ATTENTION TO COSTS**

While a broad index of socially responsible stocks has kept pace with the S&P 500, that's before investment fees are factored in.

Many socially responsible investing funds—including passively managed ones—charge more in fees than basic index mutual funds and ETFs.

For example, iShares MSCI USA ESG Select ETF (KLD) charges an annual expense ratio of 0.50% of assets per year. That's almost half a percentage point more than the fees charged by Schwab Total Stock Market Index Fund (SWTX), which offers you broad exposure to the domestic stock market.

Not surprisingly, iShares MSCI USA ESG Select has lagged Schwab Total Stock Market Index by about half a percentage point a year for the past decade.

This is not to say that you can't find inexpensive ESG funds. For instance, the iShares MSCI ACWI Low Carbon Target ETF (CSBT)—which aims to reduce "carbon emissions by underweighting investments in high carbon footprint companies"—charges just 0.20%.

**FOCUS ON FOCUSED SRI FUNDS**

The problem with investing in extremely broad socially responsible funds is that they attempt to invest in companies that score highly on several fronts—sustainability, carbon emissions, social justice, equal pay, among others.

But if a company is terrific on one front (say, carbon emissions) yet lousy on another (for instance, diversity and equal pay), should you reward it or punish it?

Rather than going with a broad ESG fund, you're better off focusing on a targeted option that promises good behavior on just one front. Chances are, the fund will be more successful at fulfilling its mission. Plus it will be easier for you to keep tabs on such funds to make sure they're living up to your standards as well.

So, if you believe women should represent a greater share of a company's executive suite—not only because you believe it's the fair thing but also because you think it will lead to stronger corporate governance and performance—then allocate a small portion of your portfolio to SPDR SSGA Gender Diversity ETF (SHE), which charges 0.25% a year.

If you're Catholic and want to promote the values of your religion, look to the Global X S&P 500 Catholic Values ETF (CATH), with a fee of 0.29%. Worried about sustainability and global warming? Consider SPDR S&P 500 Fossil Fuel Reserves Free (SPXY), which charges 0.20%.

These funds aren’t just focused in their ESG approach, they're cheaper than average as well. And that’s key, as you can't let your pursuit of social values get in the way of finding good value.