4Q2021 White Paper
Understanding ESG Investing

Many investors have recently heard about a fast-growing form of investing called ESG investing. ESG investing or Environment, Social and Governance Investing is not new. Its roots can be traced back for decades as it falls under the more general investing principle of Socially Responsible Investing (aka SRI) or sustainable investing. Several dynamics have influenced a renewed interest in ESG: The pandemic, a global green energy initiative, the ongoing need for corporate diversity, and the growing number of social injustices. So, what is ESG investing? What are its complexities and risks? How does this ideology fit into a client's long-term portfolio?

ESG investing has grown exponentially in recent years. Over the past five years global ESG assets have increased by 65% and they are estimated to exceed $50 trillion by the end of 2025. To put that in perspective, that would amount to more than one third of the projected global assets under management by 2025.[1]

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Past performance is not indicative of future returns

What is ESG Investing?

As can be seen in **table 1**, the idea behind ESG investing is to choose companies that operate their business in a sustainable manner where their core principles fall within one or more of three primary pillars (i.e., environmental sustainability, certain social elements, and a responsible governance framework).[2] ESG investing has seen a surge in demand for several reasons. First, by fitting one or more of these criteria, the company is perceived to have a positive impact on the world by operating its business in a way that can impact and/or change many of society's current contentions. Second, there is the unproven theory that just because a company fits within the ESG criteria it should deliver better long term returns for investors because the business focuses on broader values (e.g., employees, community) than just value for the shareholders and/or CEOs.

Table 1

Examples of ESG Investing

Source: https://www.nerdwallet.com/article/investing/esg-investing Oct 19, 2021

Environmental	Social	Governance
Carbon Emissions	Employee Gender and Diversity	Diversity of Board Members
Air and Water Pollution	Data Security	Political Contributions
Deforestation	Customer Satisfaction	Executive Pay
Green Energy Initiatives	Company Sexual Harassment Policies	Large-Scale Lawsuits
Waste Management	Human Rights at Home and Abroad	Internal Corruption
Water Usage	Fair Labor Practices	Lobbying

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Understanding the complexities and risks of ESG investing

The idea behind ESG investing is well intentioned and we think it will continue to evolve as an investment philosophy. The positive perspective of ESG investing is that there is a need and desire from investors to be able to put their money into causes that makes them feel good about how they invest and aligns with their values. However, before investing in an ESG marketed fund, investors should understand that the methodology behind choosing investments that fit into the ESG framework can be very nebulous. When purchasing an ESG mutual fund or exchange-traded fund, investors may not necessarily know what they are investing in. Some of the shortcomings about this form of investing, in its current form, include:

- **No universal or defined criteria.** Many different fund managers use their own system and develop their own criteria to decide which companies fit the ESG framework. There is no universal standard or regulatory authority that monitors the companies that publicize themselves as ESG companies. Instead, third party providers (e.g., Morningstar) or independent agencies (e.g., Sustainability Accounting Standards Board) use different methodologies to evaluate and/or rank a company in respect to how it conducts business with an ESG mindset.

- **One investor's belief may not be another's.** In a perfect world, it would be ideal to invest in an ESG fund that holds only companies that align with your personal values and then delivers attractive long-term returns. However, in a realistic world, not every investor sees ESG investing the same which makes a fund with many different companies not as representative of one's personal values. For example, one investor may believe in nuclear energy as a clean alternative to fossil fuels while another investor may think nuclear energy presents a danger to society.

- **Fees are generally higher.** Choosing individual companies that represent the ESG universe takes a significant amount of due diligence and manpower to comb through individual company standards and financial reports. Therefore, fees for ESG mutual funds tend to be higher than traditional funds. According to the 2020 Morningstar U.S. Fund Fee Study, the average expense ratio of mutual funds is ~0.40%. However, investors in "sustainable funds pay a greenium" compared to traditional mutual funds with the average expense ratio of these funds at ~0.60%.

- **Concentration risk.** When an investor chooses an ESG mutual fund they could be subjecting themselves to a dangerous investment risk that they may not be aware of. For example, a recent research study on the universe of ESG funds showed that ESG funds have a high concentration in technology stocks. The same research study showed that the average ESG fund has ~30% weighting in the technology sector (S&P 500 weighting ~27%) and one in 15 ESG funds has more than a 40% weighting in technology.[4] Not only does this subject an investor to concentration risk, but expensive technology stocks are more sensitive to rising interest rates and inflation than lesser valued companies.

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- **No perfect company.** Because there is not a universal or defined criteria in the selection process of ESG companies, there may be one company in the fund that satisfies one pillar of ESG investing but is lacking in another area. Does that constitute a true ESG investment? For example, imagine a company that has strong green energy initiatives but lacks diversity on their board of directors. This presents a problem for investors who believe strongly in both social issues and may not know they are not getting both when investing in the fund.

- **Regulations are likely coming.** In May, the Securities and Exchange Commission released an ESG "focused risk alert" for those offering ESG funds to investors. They highlight many of the shortfalls in the rapid expansion of ESG offerings to investors. Some of the concerns the SEC outlined include an inconsistency in ESG disclosures to clients, lack of monitoring of a company's adherence to ESG, misrepresentation in marketing materials and deficiencies in a clearly defined selection process. Given how fast this investment philosophy is growing, we believe it is inevitable that regulators will propose clearly defined rules around how and if a fund can market itself to the public as an ESG investment. This could create volatility across the ESG fund universe as it stands currently.

Buyer beware: A grey area exists in defining ESG investments. The ability to charge higher fees, an increase in consumer interest, and loose regulatory guidelines make it attractive for funds to market themselves as ESG, which in some cases, can be considered a stretch.

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Verdence View on Investing in ESG

We agree that ESG investing is noble in theory. We are seeing companies take notice of investor demand for change and evaluate how they operate their business so that they can be a part of this growing form of investing. However, as fiduciary advisers we would be irresponsible to not educate our clients on the shortcomings associated with the investment vehicles in this space. While there are many funds with successful track records, it is nearly impossible to decipher between whether that is good stock picking in the strongest bull market in history (especially the tech bull market) or that the underlying companies are truly doing well because they fall within an undefined criterion of being ESG companies. We are apprehensive that some fund managers are taking advantage of investor emotions to sell funds that may not represent true investor intentions. This has been echoed by regulators that are likely to get involved so that investors are not being misled.

We think that investing in a way to effect true change is deeply personal and should be left in the hands of the investor, not a fund manager. As the industry grows, we have witnessed the development of some funds that are more targeted to one specific ESG area (e.g., green energy). However, we recommend appropriate due diligence and understanding about return and risk. Another way investors may consider investing with a purpose is to make direct contributions and involvement in nonprofit organizations or companies that adhere to your personal values and beliefs.

If you have any questions, please feel free to contact your financial advisor.

1. https://www.reuters.com/business/sustainable-business/sustainable-investments-account-more-than-third-global-assets-2021-07-18/
2. https://www.nerdwallet.com/article/investing/esg-investing
3. https://www.morningstar.com/content/dam/marketing/shared/pdfs/Research/annual-us-fund-fee-study-updated.pdf
4. https://www.wsj.com/articles/risks-of-esg-funds-11631539404

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