SIG

Portfolio Group
ESG Investment Strategies

Texas SIG

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OVERVIEW OF ESG INVESTMENT PRACTICES

Investment management firms did not practice ESG until the term was popularized in 2005 by the “Who Cares Wins” study. However, since the 1920s, alternative investment strategies including socially responsible investing have existed in theory rather than practice. ESG investment management was a development of corporate social responsibility, whereas more investors saw the value in both ESG profit margins and sponsoring ESG conscious organizations. As of 2018, ESG investments accounted for over $12T in assets. ESG investing is an umbrella term for firms which use environmental, social, and governance impact as a factor in investment. Thus, firms differ along investment strategy because they look at different ESG metrics, seek different investment returns, and tolerate varying levels of risks. In addition, they may bar certain industries based on internal criteria. Currently, there are five main ESG investment strategies: exclusionary screening, positive screening, ESG integration, impact investing and active ownership. These strategies can be practiced by themselves or combined because the right investment can satisfy the goals of stakeholders with varying ESG strategies. Firms raise more capital and better satisfy the needs of stakeholders when they use their ESG strategy to create a common vernacular.

Exclusionary screening is a basic method investors use to exclude certain industries, companies, or sectors from consideration regardless of what their investment returns are. This strategy is derived from aligning the values of stakeholders with those of the potential investing company. For example, Norway declared in 2019 that it would divest all of its oil investments from its national sovereign fund, amounting to over $6.2B, over concern for climate change. SIG should consider using exclusionary screening for certain industries and practices such as child labor. This ensures that the organization's shared values are represented by its investment portfolio. In addition, this will force analysts and fellows to research less explored investment classes, contributing to their overall finance education.

Positive screening focuses on ESG metrics from reports to invest in companies which are either currently outperform similar companies along ESG standards or improving faster than similar companies along ESG metrics. Positive screening emphasizes finding the intersection between maximum return and supporting ESG-oriented companies. In addition, positive screening can include thematic investing, which is when a firm invests specifically looking to solve a certain set of issues. For example, a firm may look for companies which focus on container waste reduction. SIG should practice positive screening in the long-run. However, it should note that it is currently difficult due to lack of reputable, comparative ESG data between similar companies. As more companies focus on corporate social responsibility and adapt to the growing prevalence of ESG investing, ESG data will be more accurate and widely published.

ESG integration occurs when a firm simultaneously uses ESG investing metrics and traditional financial analysis to execute investments. Firms which focus on this strategy typically seek higher returns than other ESG investment strategies and primarily use ESG as a tool for raising capital as opposed to creating impact. However, if used in moderation, it can help create variant market views informed by environmental, social, and governance factors. Depending on how finance-oriented SIG becomes, the organization should consider complementing its ESG-based market analysis with traditional finance analysis for a more comprehensive understanding of the company.

Impact investing focuses on specific social and environmental benefits of a project and is highly discriminatory in regards to selection. Frequently, these investments are done at rates lower than the market rate because they are projects which focus on social/environmental benefits rather than returns. Thus, these projects could not necessarily receive traditional financing from other sources. This type of investing is more akin to a non-profit because it distributes limited funds to causes which likely cannot qualify for normal financing. SIG should avoid impact investing because it does not yield high enough returns and investments typically cannot be recouped if projects fail.
Active ownership entails investment firms owning substantial enough stakes in a company to exert pressure in board meetings to push the company towards better ESG incorporation and CSR practices. Although it can provide significant incentive for a company to collect and publish ESG metrics, it costs significant capital to own a substantial enough share of the company to single handedly foster these changes. Due to limited capital and lack of board room experience, SIG should avoid this strategy.

GENERAL TYPES OF ESG INVESTMENTS

Socially responsible funds that we have researched include QCSCRX and VFTSX. QCSCRX's top holdings include Apple, Microsoft, Amazon, US Treasury Bonds and Google. QCSCRX has a one year return of 0.11% and has $13,247.76 million in net assets. Overall, the fund distribution is 58% stocks and 40% bonds with 18% being allocated to the tech industry. VFTSX has similar top holdings including Microsoft, Apple, Facebook, JP Morgan and Google. But the allocation of the fund is very different, 99% of the VFTSX fund is made up of stocks. The one year return is 21.36% and net assets total $6,744.77 million, approximately half of QCSCRX. Another notable fund is OPEIX. Its top holdings are Veolia Environnement SA, American Water Works Co Inc, Ecolab Inc, Waste Management Inc, Equinix Inc and Thermo Fisher Scientific Inc a difference in the tech focused aforementioned funds. 97.32% of assets are allocated to stocks. The top sector that the assets are allocated in is industrials.

To better understand how funds might be evaluated regarding ESG and sustainability criteria we looked into the MSCI fund metrics. The metrics provide insights across three dimensions: sustainable impact, values alignment and risk. Sustainable impact has to do with measuring exposure to companies that address core environmental and social challenges. Values alignment evaluates alignment with ethical, religious and political values. Finally, risk metrics are used to assess fund exposure regarding ESG-related risk.

Looking at more niche mutual funds, one company, Parnassus Investments, is proof of tailored yet strong ESG portfolios. First, the Parnassus Core Equity Fund is a $17.5 billion dollar fund in fossil-fuel free companies. It is categorized as a large-cap growth fund, but specializes in socially responsible investments. It utilizes its own ESG criteria, and it's top holdings is the previously mentioned Microsoft and Google, along with others like Comcast, Verizon, and Danaher. Parnassus also breaks down its fund through ESG parameters. For example, the top performers for Social Impact in their fund were Gilead Sciences for treating major diseases and Procter & Gamble for its sale of sanitary products. For Environmental Impact, Digital Realty Trust placed at the top for deriving approximately 63% of its revenue from products or services that help reduce energy consumption and 22% of its revenue from operation, management, development or construction of green-certified properties. Another mutual fund by the firm is the Parnassus Endeavor Fund, which focuses on company social profiles as a workplace and corporate citizen. They believe these companies are more competitive with higher productivity, innovation, and most importantly, profitability. They see a strong workplace environment as a key to company success in the long term. The fund also avoids fossil-fuel companies

Our research recognized Exchange Traded Funds as a simple way to look at the most commonly held firms within ESG funds that might warrant further analysis. For example, more than 15% of the iShares ESG MSCI USA Leaders ETF is just Microsoft and Google. Johnson & Johnson, Visa, and Procter & Gamble round out the top five. Digging deeper into the top holdings of these ETFs can be a strong starting point, and looking at the stocks with lower weight for deeper analysis might help us identify key differences in what differentiates a strong ESG investment from a poor one.

Switching gears to Fixed Income, the ESG loan market is currently $71 billion dollars. Common debt structures include terms where interest rates vary based on hitting key ESG metrics and payoffs for companies that manage ESG risks or meet sustainability goals. There is also the concept of “Greenium”. The presence of a ‘greenium‘ would suggest that bonds labelled as green, social or sustainable would trade at tighter levels than those of conventional bonds. Green bond issuers provide investors with greater clarity due to greater reporting requirements. As ESG bonds move into the mainstream, ratings firms have been catching on. According to the Moody’s website, “Over the past three years, Moody's has been intensifying its effort to increase the transparency around how it incorporates ESG considerations into its analysis of credit quality,” S&P Global Ratings also factors ESG into its ratings. Breckinridge Capital Advisors, an investment grade fixed income portfolio manager, has long specialized in ESG because it “often reveals management priorities; a management team that prioritizes ESG risks and takes advantage of sustainability to drive revenue growth is better positioned over the long term.” ETF’s like SUSC and SUSB both give exposure to Corporate Bonds from highly rated ESG funds. Top fund weights are again common names like Microsoft and Bank of America, but there are a lot more companies within the fund, with more than 2,100 firms in SUSC.

Emerging markets debt could also be fertile ground for future ESG bond growth. Efforts in China and India, among other developing economies, to cut pollution and reduce carbon footprints, could drive the use of ESG bond ratings outside the U.S.

Finally, we also evaluated stocks in the context of ESG principles. Noteworthy stocks that we have found include Hasbro (HAS) and Home Depot

(HD). Hasbro focuses on protecting the environment through their sustainability initiatives. They eliminated wire ties in 2010, and a couple years later added labeling with information on how to recycle for their products. In 2020, they began eliminating plastic from the packaging of their new products. They are hoping to remove all plastic from product packaging by 2022. Furthermore, they are involved in local communities all across the globe. Hasbro has a global partnership with terraCycle, allowing others to recycle toys and games, products that sometimes include hard-to-recycle materials. They are also involved with communities in a more direct way through philanthropy. 94% of Hasbro's global workforce volunteers in local communities through Hasbro's volunteer team.

We also evaluated the industry and financials of the company to better evaluate the investment opportunity. Hasbro is better positioned than other traditional toy companies because it has been positioning itself to take advantage of the rapidly growing demand for digital entertainment. By adapting to the shifting industry, Hasbro was able to realize a 5% increase in revenue even though toy industry sales declined. Furthermore, CEO Brian Goldner mentioned that Hasbro has experienced an increase in demand even in the midst of COVID-19 as many parents turn to Hasbro's games to keep children entertained while stuck at home.

Regarding financials, Hasbro doesn't have a traditionally "strong" balance sheet when evaluating their cash and debt, but Goldner's decision to not lay off any employees during the pandemic hints at the financial strength of the company.

Furthermore, we looked into opportunities for growth and possible headwinds. There is potential for growth in the e-commerce space as Hasbro currently mainly focuses on brick and mortar stores. Growth can also come from an increase in demand for Disney+ content related toys. Furthermore, Hasbro is looking to develop new digital games to increase its presence in the online gaming space. Hasbro's acquisition of Entertainment One is also notable as it allows Hasbro to expand into the film industry.

Finally, another stock that aligns with ESG principles is Home Depot. Home Depot operates both sustainably and ethically. Home Depot is on track to harness renewable or alternative sources to get 135 megawatts of energy by 2020. They are also working to reduce customers' greenhouse gas emissions by 20 million metric tons by 2020. They also pay careful attention to their suppliers. For example, they do not procure wood harvest from endangered rainforests. They only accept wood products certified by the Forest Stewardship

Council, avoiding wood from Papua New Guinea, the Solomon Islands, the South American Amazon Basin or the African Congo Basin.

Home Depot also has a strong focus on its people. It has a wide variety of wellness and personal development programs along with a very successful Success Sharing Profit Sharing program. They are also heavily involved in local communities. In the past decade they have invested more than $335 million in veteran causes and improved more than 47,000 veteran homes and facilities in 4,500 cities with a goal of reaching half a billion in contributions by 2025. They also provide many grants to nonprofit organizations.

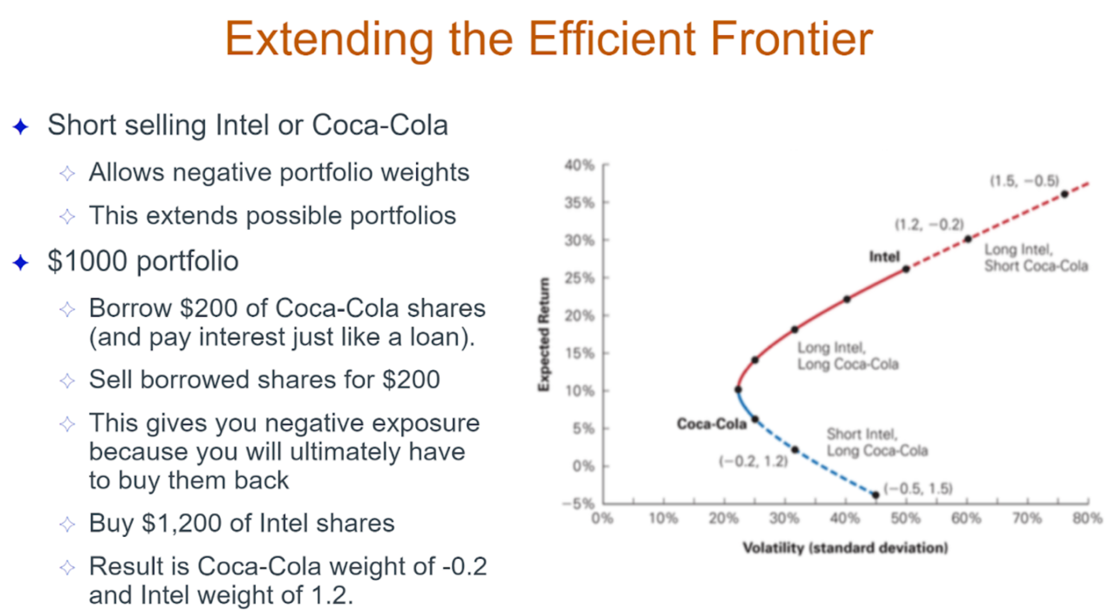
For expanded growth, Home Depot is heavily investing in the integration of physical and online sales. Historically, Home Depot's profitability has been impressive and in the long term, the focus on integrating physical and online sales should further increase margins.

PORTFOLIO ALLOCATION METHOD

Passive Investment Percentage Allocation

If SIG compares its portfolio to a custom benchmark of mixed asset allocation rather than just the S&P, our allocation choices could be made more independently. This is because we would be comparing our mixed portfolio of different asset types to a benchmark portfolio with a similarly allocated portfolio which does not consider ESG. SIG could also do an ESG comparison by comparing the SIG portfolio to a portfolio that is made up of competitors of our portfolio who have similar ESG scores. This will allow SIG to determine which companies have the highest investment return given similar ESG scores.

Potential short opportunities:



Depending on funding levels, if a team pitches a short, the excess cash could be used to make the portfolio more efficient.
Image credit: Scott Bauguess

Black Swan Preparation

Since SIG's portfolio will likely be long biased, the organization could take a percentage of the expected returns of the portfolio derived from members DCF's, members calculated YTM, or analyst expectations and invest in trailing put options or shorts on companies that follow the market, but do not follow all of our ESG principles as a hedge in relation to portfolio allocation. This strategy would also be dependent on macro sentiment that would affect the price of these options. An example of this would have been OXY (Environmental, Social, & Governance) or MANU(Governance) puts pre-COVID. Indexes would also work as well. A concern on this front would be industry diversification; however, we could give members insight into portfolio diversification using Morningstar-like graphs. As many of the members' interests revolve around renewable/clean energy, renewable/clean energy is likely to make up a significant portion of the portfolio. The organization should consider having a small long position in an O&G vertical as a hedge, if the members are willing to given the ESG implications.

Allocation Strategy Examples

One allocation strategy is the exclusion of industries with poor ESG ratings. For example, iSPDR S&P 500 Fossil Fuel Reserves Free ETF tracks the S&P 500 Fossil Fuel Free Index, which avoids companies that generate or require storage of fossil fuel reserves. This is appealing to risk averse, climate cautious investors. The downside of this strategy is that the majority of holdings are technology or financial services focused firms and only 1.22% of the fund is composed of energy companies. While the index successfully avoids fossil fuel reserves, it also does not adequately provide support for alternative energy firms. Another example of this strategy comes from the MSCI KLD 400 Social Index which excludes weapons, tobacco, alcohol, nuclear energy, and genetically modified foods. To implement this strategy, SIG could hold a vote on the industries we wish to avoid at the beginning of every year and exclude companies from those industries from the portfolio.

Another strategy is demonstrated by the MSCI USA Extended ESG Select Index. This index tracks 100 companies in the US and bases portfolio weight based on ESG score. This means that the better the ESG score, the more heavily the fund is invested in the firm. Again, given that the top holdings are Microsoft and Apple, it is arguably ineffective as a means of change although it is also heavily invested in Ecolab Inc. which is an environmental top performer and provides water, hygiene, and energy technologies. In order to implement this strategy, SIG can develop an algorithm to determine weight based on a combination of factors including ESG score, beta, and other financial metrics.

A third strategy can be seen in the MSCI ACWI Low Carbon Target Index. Instead of screening for ESG score, the index screens for a single environmental metric: greenhouse emissions. The primary advantage of this strategy is that it allows investors to support more targeted goals. CRBN specifically aims to maintain global stock exposure and invests in mid to large cap companies. Although the index is focused on firms with low greenhouse emissions, it does not exclude high emission firms, it simply underweights them. It would be much more difficult for SIG to replicate this strategy, but again, an algorithm may be developed to determine the weight of companies based on a mix of emissions data and financial metrics.

An additional interesting strategy is utilized by the SPDR SSGA Gender Diversity Index. The index screens for the top 10% of firms based on gender diversity from 1,000 largest firms in the US based on market capitalization. Gender diversity is measured by taking the percentage of women who hold executive and director positions and firms qualify as long as there is one woman on a firm's board, or the sitting CEO is a woman. Then, the firms are weighted based on market capitalization in the portfolio. Unfortunately, the portfolio holds a 5.23/10 or BBB MSCI ESG rating in terms of resiliency and opportunities from ESG factors. This strategy does allow for a more diverse selection of top holdings including Visa, Johnson & Johnson, and Wells Fargo.

A final noteworthy strategy is to invest in the most ESG friendly firms in each sector. This allows for full diversification in terms of sector and unsystematic risk but does lower the ESG score of the entire portfolio due to firms from non-ESG friendly industries. This strategy is somewhat followed by the MSCI ACWI Low Carbon Target Index.