‘S’ Is For Social

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The concept of environmental, social and governance (ESG) investing grew out of the social aspect, which allows investors to use their money to effect change.

ESG investing was first known as socially responsible investing, and some people in ESG finance trace the roots of social impacts to the late 18th-century Quakers boycotting sugar on moral and economic grounds to oppose slavery.

Jay Jacobs, head of research and strategy at Global X, which issues the **Global X Conscious Companies ETF (KRMA)** and the **Global X S&P 500 Catholic Values ETF (CATH)**—the latter of which is one of the largest socially focused ESG ETFs, with more than $300 million in assets under management—regards the social pillar as one of the most important parts of ESG.

“When you think about the feel-good story about aligning people’s investments and their personal beliefs, a lot of that’s coming from the ‘S,’” he said. “But it’s also where you have the widest divergence of opinions.”

Tough To Quantify

Despite “social” being the foundation of ESG, this pillar has the hardest aspects to quantify, especially in investments like ETFs. Unlike the “E” and “G” in ESG—which have more transparent and measurable metrics for gauging impact—“S” still has challenges, says Michael Lohmeier, chief investment officer of Impact Community Capital, which uses securitizations for private investment in affordable housing.

"Measuring impact in "S" for companies can be more difficult, often due to a lack of transparency and standardization," he explained. "A company's product, service and operating environment will dictate what material impact it might have on 'S,' but it may be different, potentially, for each company."

Despite the difficulties, there are ETFs that prioritize the social aspect of responsible investing, versus broad-based ESG ETFs, and fund issuers are using diverse methodologies to achieve these goals.

Getting Priorities Straight

Ethan Powell, founder of Impact Shares and issuer of two ESG-focused ETFs—the **Impact Shares YWCA Women's Empowerment ETF (WOMN)** and the **Impact Shares NAACP Minority Empowerment ETF (NACP)**—notes fund issuers first need to decide what social policies and impact they want to achieve.

Different Ratings Firms Mean Different Scores: The 20 Largest Market Cap Companies In the US, 12/31/2017

			ESG Score		E Score		S Score		G Score	
Company	Sector	Weight	Provider 1	Provider 2	Provider 1	Provider 2	Provider 1	Provider 2	Provider 1	Provider 2
Apple	Technology	3.52%	0.41	0.43	0.69	0.96	0.10	0.42	0.54	0.19
Amazon	Cyclical	2.82%	0.23	0.07	0.25	0.13	0.15	0.20	0.51	0.06
Microsoft	Technology	2.78%	0.88	0.94	0.89	0.92	0.90	0.83	0.74	0.84
Alphabet	Technology	2.76%	0.33	0.48	0.54	0.67	0.50	0.75	0.10	0.10
Facebook	Technology	2.00%	0.29	0.20	0.77	0.23	0.32	0.63	0.07	0.01
Berkshire Hathaway	Financial	1.97%	0.04	0.04	0.06	0.07	0.04	0.24	0.04	0.04
JPMorgan Chase	Financial	1.53%	0.79	0.76	0.97	0.75	0.88	0.82	0.45	0.45
Johnson & Johnson	Health Care	1.34%	0.95	0.87	0.95	0.90	0.97	0.45	0.78	0.92
Bank of America	Financial	1.27%	0.59	0.81	0.86	0.79	0.58	0.88	0.29	0.54
Exxon Mobil	Energy	1.24%	0.70	0.53	0.45	0.35	0.65	0.91	0.86	0.37
Wells Fargo	Financial	1.10%	0.84	0.31	0.82	0.87	0.80	0.30	0.70	0.03
Visa	Financial	1.07%	0.75	0.65	0.67	0.63	0.53	0.37	0.98	0.71
Walmart	Cyclical	1.03%	0.72	0.35	0.64	0.77	0.61	0.10	0.73	0.42
Intel	Technology	0.89%	0.75	0.99	0.81	0.84	0.99	0.99	0.37	0.99
Cisco	Technology	0.86%	0.98	0.98	0.88	0.86	0.95	0.98	0.93	0.78
AT&T	Telecomm	0.86%	0.94	0.86	0.98	0.82	0.84	0.50	0.80	0.87
UnitedHealth Group	Health Care	0.84%	0.18	0.51	0.16	0.60	0.20	0.16	0.40	0.67
Pfizer	Health Care	0.84%	0.68	0.67	0.65	0.59	0.85	0.66	0.39	0.57
Chevron	Energy	0.82%	0.32	0.30	0.32	0.21	0.41	0.87	0.35	0.25
Boeing	Industrial	0.82%	0.51	0.24	0.48	0.42	0.38	0.08	0.63	0.47

Note: In order to normalize ESG scores between the two providers, the scores in this table are determined by the percentile ranking of each company (with 0 being the lowest and 1.00 being the highest) by the respective provider's raw ESG score (or individual environmental, social and governance score) and then taking the cumulative market cap weight of that company reltaive to the overal universe. For example, Apple's ESG score of 0.41 by Provider 1 means that Apple's cumulative market cap weight within the investment universe is 41% after ranking the universe by Provider 1's ESG scores.

Source: Research Affiliates, from "What A Difference An ESG Ratings Provider Makes!"

Note: The shaded areas indicate where the two ratings providers have ratings differences greater than 25%

Note: "Social" ratings demonstrate the most divergence in this comparison of ratings from different firms.

For a larger view, please click on the image above.

“We wanted to be very explicit with the social aspect we want to address,” he noted.

In its alliance with the NAACP, the fund company worked with the organization on how the group thought it was best to compile and analyze the public and private data available, and what the organization wanted to emphasize.

Powell says that, sometimes, investors take issue with certain companies included in the funds, using NACP as an example. Some mission-aligned investors have a “negative, visceral reaction,” he says, to having companies like Microsoft or Amazon in the fund, which these investors say are two companies that are underrepresented from a diversity standpoint regarding board makeup and corporate leadership.

He counters that critique, noting these two companies have adopted the Rooney Rule, which is a National Football League policy requiring league teams to interview ethnic-minority candidates for heading coaching and senior positions, and they are taking steps in the right direction in the technology sector.

Noel Archard, global head of SPDR product for State Street Global Advisors, says the firm looks at ESG in two ways: “There’s the value aspect, meaning, do any of the data points within the ‘E,’ the ‘S’ and the ‘G’ actually help you from a risk/return investment perspective?”

Then there’s the values lens, where social issues are part of the investment scheme, he notes. “Ideally, you’re solving for the value, and you get the values along with that,” he said. “If you do it right, you’re able to address those constituents.”

Conflicting Goals

Sometimes, social goals fly in the face of other social goals, Powell explains, and fund issuers need to consider that. He pointed to tobacco company Philip Morris International as an example: “Philip Morris is actually very good as it relates to their business practices for African Americans. They have community engagement programs, digital programs that do a lot of [positive] things. The problem is, their flipping product kills the constituent.”

Philipp Aeby, CEO of RepRisk, an ESG data science firm that identifies companies and projects that are exposed to material ESG risks, concurs, suggesting that people may want to consider the company overall when evaluating investments: “With ESG, some companies can have great labor standards or great employee relations, but they may be a polluter.”

Because of their size, large companies inevitably will have conflict issues, Aeby points out, and ESG raters can correct for company size, and benchmark the company to others in the industry to come up with an appropriate assessment. That helps to cut down on "greenwashing," and investors are becoming more sophisticated regarding companies trying to fluff up their social bona fides.

"People are starting to question asset managers on existing products for their ESG credentials," Aeby said. "Our job is to see if the company walks the walk."

Differing Metrics

Global X's Jacobs says the metrics a fund provider uses for social can differ. For CATH, it was straightforward, he notes, as metrics were based on the U.S. Conference of Catholic Bishops' investment guidelines. For KRMA, it was based on how people think about corporate social responsibility, selecting companies that take a conscious approach to how they operate and seek to optimize the outcomes for all stakeholders.

What it comes down to, for both fund issuers and investors, is that both entities have to be very specific with what they consider a social priority, Powell says.

Andrew Behar, CEO of As You Sow, a nonprofit shareholder advocacy group, which also has a website that grades funds on ESG metrics, notes that social metrics lag behind environmental and governance metrics because there's less data.

"With diversity, it's hard to rate and rank because it's illegal to ask somebody their ethnicity, even on boards," he said. "We don't know, so we don't have this in our database; otherwise, we'd include it. You can't ask board members their sexual orientation."

Wary Of Social Aspects

Some financial advisors who invest in ESG products remain wary about social investing. Blair duQuesnay, investment advisor representative at Ritholtz Wealth Management, explains they approach ESG from a risk management perspective, making sure ESG isn't harming portfolio performance: "From that angle, social becomes an add-on after that, based on clients' values."

It's not that her firm isn't prioritizing social aspects, but for her, social screens are still something akin to the previous way advisors approached ESG, with negative screens eliminating whole industries. Because some social funds are more niche, duQuesnay notes, those can be difficult to figure out how to properly place in a portfolio.

"The question is, what do you do? Is something like the **SPDR SSGA Gender Diversity Index ETF (SHE)** at the core of a portfolio, or is it a percentage of a portfolio?” she said. “If that’s an issue that’s really important to a client, should it only be a small slice of a portfolio? It’s a very difficult decision when you get into these niche topics.”

While some people may be skeptical about how social impacts are represented in ETFs, that could change. As more data becomes available, methodologies will morph, SSGA’s Archard observes: “The more clients use ESG products, the more sponsors launch ESG products, the more the taxonomy gets defined.”