



What You Need to Know About Values Investing

More funds are looking for companies that pay attention to environmental, social and corporate governance factors.

By [NELLIE S. HUANG](#), Senior Associate Editor
November 1, 2018
From *Kiplinger's Personal Finance*

Socially conscious investing has gone mainstream. Many people now factor environmental, social and corporate governance criteria—the triumvirate that define so-called sustainable investing—into their portfolio decisions. And they're not all millennial tree huggers.

Schroders, a worldwide investment firm, reports that over the past five years, 70% of U.S. investors have increased their allocation to ESG investments. Some have deep pockets. In 2018, 43% of U.S. institutional investors—endowments, foundations and pension plans—incorporated ESG factors into their decision-making process, nearly twice the percentage in 2013. Part of the reason: A growing body of evidence shows that investors don't have to give up returns to invest sustainably.

Naturally, investment firms are answering the call with new products. More than 170 sustainable investing funds have debuted over the past five years, along with apps that promise to align your portfolio and your values. In June, for example, Newday Investing launched an app through which investors can access proprietary stock portfolios tailored to six themes, including climate change and gender equality. "Every type of investor, from the largest pension funds to individual investors, is expressing significant interest in responsible investing," says John Streur, head of Calvert Research and Management, one of the oldest sustainable investing firms in the country.

You don't have to be a climate-change zealot or burn with desire to save the world to benefit from this approach. Many ESG tenets make good business sense and, therefore, good investment sense. We'll tell you what the ESG characteristics are

all about and why some make a difference in company performance, as well as the best way to invest with ESG in mind.

A Long Evolution

The first socially conscious investment fund—as such funds were usually called before sustainable became the term of choice—opened in 1952. Over time, the focus has shifted from what couldn't be included in the fund—firms that derive a majority of revenues from alcohol or tobacco, for example, or those in the gambling or nuclear power industries—to companies that are doing better than their peers when it comes to ESG criteria. “The question now is how do we differentiate how good one company is from how good another is? That's a positive change,” says Streur.

The best ESG companies, in a nutshell, are mindful of their environmental impact; treat customers, suppliers and employees well; and are run by a diverse pool of managers who are aligned with shareholder interests. Firms that excel in these areas, ESG advocates maintain, will be more successful over the long haul than companies that don't.

It turns out they are right. Socially responsible companies, research shows, benefit financially from their efforts. Numerous studies show that these firms exhibit enhanced operating efficiency, improved employee productivity and better risk management compared with firms that lag behind on ESG values. A 2011 Harvard Business School study, for instance, found that from 1993 to 2010, a portfolio of 90 companies with a high quotient of sustainability characteristics outperformed a portfolio of 90 low-sustainability companies. The high-sustainability portfolio was worth 22% more at the end of the 18-year period. “ESG factors matter,” says Calvert's Streur.

What Matters Most

Some ESG measures matter more than others, however. Diversity on the board of directors and executive team, for instance, has been shown to boost company performance in a broad swath of industries. A McKinsey study found that firms that ranked highly for ethnic diversity on executive teams were 33% more likely to log above-average profits for their industry than firms that didn't rank well. Firms with at least three women on the board showed a 37% increase in earnings over a five-year period between 2011 and 2016 versus an 8% drop for firms with no women on the board, according to an MSCI study.

But other ESG characteristics vary in importance, depending on the industry you're talking about. Environmental issues, such as how efficiently natural

resources are used, matter more for transportation companies. Social concerns, such as high employee retention, matter for people-dependent businesses, such as retailers. Governance issues, such as risk management and business ethics, are paramount for financial-services firms.

These days, some of the biggest socially conscious investors—fund firms such as Ariel Investments, Calvert, Parnassus Investments and Schroders—are trying to make a direct impact on issues that are important to them. They are sitting down with company executives to advocate for their values or even ask for a particular course of action. “We don’t go in and demand changes,” says Tim Fidler, director of research at Ariel. “We work with companies to move them further down the field on issues that we think matter. This is where ESG is going.”

Some Parnassus funds, for instance, held on to Wells Fargo shares well after the bank admitted to its aggressive customer account schemes. The reason, in part: Parnassus, along with other shareholders, hoped to persuade Wells Fargo to donate profits from a controversial oil pipeline project it was helping to finance to Native American communities impacted by the pipeline. In late 2017, the bank agreed to give \$50 million over five years. “It was good for the bank’s brand and for the community,” says Todd Ahlsten, Parnassus’s chief investment officer. With billions in assets under management, “Parnassus has a big seat at the table,” he adds.

How to Invest Sustainably

A range of investing approaches can help you put your money where your heart is. Some strategies limit the portfolio to holdings that align with certain values or themes. Faith-based funds or overtly ESG-themed funds, such as those focused on the environment, fit in here.

Others focus on making a measurable impact. Impact approaches include funds that invest in projects (typically private enterprises) that make a noticeable difference in a particular area. A wealthy family’s private investment fund might invest in a group that plants trees in deforested areas, say, to help the environment and create jobs for local communities.

Finally, some strategies integrate ESG values into more traditional investment analysis. In other words, a firm’s emissions record, say, or its business ethics or how well it treats its employees, customers and suppliers may be just as important as how much debt it has on its balance sheet or whether its earnings are sustainable.

We like the last approach best. We also prefer actively managed funds because of the nimbleness required to analyze ESG factors in specific industries and companies. ESG-focused index funds are less flexible, and they also rely heavily on data providers such as MSCI, Sustainalytics, RepRisk and ISS, which rate companies on ESG factors. The scores are a good starting point (active managers use them, too), but they can be inconsistent.

Invest for Impact

If socially conscious investors expect to earn a good return while contributing to the general good, impact investors take a more targeted approach. They expect their investment to generate measurable social or environmental impact alongside a financial return. The projects, organizations and companies that these investors buy into target a range of issues and can be as broad as investing in renewable energy sources or as narrow as making loans to women-run businesses in Bolivia.

Access to these investments, which often take the form of stock or debt issued by private entities, has long been reserved for institutional investors (such as foundations or pension funds) or sophisticated, high-net-worth investors. But a 2017 survey by the Morgan Stanley Institute for Sustainable Investing found that 75% of individual investors, including 86% of millennials, expressed interest in investing for impact while earning market-rate returns. “There are growing options for individual investors who want to make a direct impact,” says Kristin Siegel, a program coordinator at Toniic, an online community for impact investors.

In general, you’ll find more impact investments among funds that hold bonds and bondlike securities or in savings instruments. For example, online savings platform CNote takes your cash and invests it in federally certified community lenders: financial institutions that promote small-business growth and job creation in underprivileged communities. Because CNote isn’t a bank, your savings aren’t FDIC-insured. If you can stomach the risk, your account will earn a non-guaranteed 2.5% interest rate. There are no account minimums or fees.

Both Calvert Impact Capital and Enterprise Community Partners offer impact notes: bondlike investments that stash pools of investor funds in a diversified portfolio of loans. You only need \$20 to invest in Calvert’s Community Investment Note, which yields 1.5% to 4%, depending on the maturity, and supports initiatives ranging from community development to sustainable agriculture in 97 countries. The Enterprise Community Impact Note, which focuses on affordable housing, health care and school construction, comes with a

\$5,000 minimum and yields up to 3.5%. Both send annual impact reports to investors.

Before choosing an impact investment, consider what role it would play in your overall financial picture. The Global Impact Investing Network's 2018 survey of institutional impact investors found that 64% expect to keep up with or beat relevant market benchmarks, with the remainder willing to sacrifice some financial return to boost their investments' impact. For investors willing to earn just enough to preserve their wealth, impact investing can complement or substitute for philanthropy.