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THE THREE KINDS OF ESG INVESTING

ESG critics have found plenty of ammunition lately, but the concerns they cite can largely be resolved by defining the three distinct strategies that make up ESG investing today

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Illustration by Max-O-Matic

As if weak returns this year among funds that focus on environmental, social, and governance, or ESG, strategies weren't bad enough, the area has faced an onslaught of new criticism that its investing decisions are arbitrary and sometimes nonsensical. It certainly does seem that way sometimes. For example, the \$23 billion iShares ESG Aware MSCI USA exchange-traded fund (ticker: ESGU) owns millions of shares of Exxon Mobil (XOM), Chevron (CVX), and ConocoPhillips (COP)—the poster children for cli-

mate change tied to human activity. In contrast, the \$27 billion Parnassus Core Equity (PRBLX) ESG-oriented fund has a formal commitment in its prospectus to be "fossil fuel free" and never buy companies that profit from oil, gas, or coal extraction or production. Such apparent contradictions can be resolved when investors understand that there are now essentially three distinct ESG investing strategies available. The first is relative: Companies are evaluated on ESG risk relative to others in their sector, and the ones that score highest can make it into an ESG index, no matter the industry (hence the oil companies in the

iShares ESG Aware fund). The second is exclusionary, avoiding certain kinds of companies entirely. Parnassus' approach fits in here. The third category is custom. Using a software-enabled approach called direct indexing, investors can exclude specific companies or industries from a portfolio based on their own personal values. Investors need to figure out the approach they favor before they choose ESG investments—not always an easy task. These distinctions are also crucial for regulators. In March, the Securities and Exchange Commission announced it would be reviewing fund marketing materials to see whether

managers are "greenwashing," citing the "lack of standardization in ESG investing terminology" as a problem. In May, the SEC proposed new, more-stringent disclosure rules for ESG funds. **Performance matters.** While individual ESG investors may care most about having their values represented, the research on whether a relative ESG approach or an exclusionary approach helps or hurts performance matters a great deal to institutional investors and to regulators overseeing retirement plans, including 401(k) plans, which have a fiduciary duty to their investors. If there is evidence that entirely leaving out sectors hurts perfor-

mance, then it could be problematic to add the exclusionary kinds of ESG funds to retirement plans. Meanwhile, to label a fund that incorporates fossil-fuel companies in its portfolios as "ESG" could be deemed false advertising by regulators seeking greater clarification on the term for investors. Regulators may need to make note of the three kinds of ESG, and insist on truth in labeling. In other words, funds like iShares ESG could have the words "Relative ESG" in their names instead of the ambiguous "ESG Aware." Regulators could also require that funds publish in their reports a "relative carbon footprint"

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measure of metric tons of carbon dioxide emissions produced per \$1 million invested, as Parnassus and Calvert already do for their funds. That would allow investors to see how “green” ESG funds truly are.

For individual ESG investors, having a more accurate “exclusionary ESG” or “zero fossil fuels” label would clarify things for them, much in the way a “no sugar added” or “USDA organic” label does on food.

Even New York University finance professor Aswath Damodaran, who calls ESG investing “the biggest scam I’ve ever seen,” admits that he avoided Monsanto stock in the past because its pesticide Roundup caused cancer. Still, he argues that by leaving the “bad” stocks out, investors will underperform.

Although this year’s oil boom and accompanying tech-stock slide has caused many ESG funds to underperform, there is no definitive long-term evidence that ESG strategies perform better or worse than their peers. According to Morningstar, of 102 mutual funds with ESG investment strategies that have 15-year track records, 52 outperformed their fund category peers and 50 underperformed. There are some ESG funds with exceptional performance, such as Parnassus Core Equity, which has beaten 99% of its peers in the past 15 years with an annualized return of 10.6%.

Critics have also targeted the high fees of some ESG funds, yet there are ESG funds with low fees, such as the **Humankind US Stock** ETF (HKND), with a 0.11% expense ratio; **Vanguard ESG US Stock** (ESGV), at 0.09%; and the **Fidelity US Sustainability Index** fund (FITLX), at 0.11%.

ESG’s proponents think critics who focus solely on performance are largely missing the point. “[They] make it sound like some kind of a scam, but normal people want to make decisions, whether it’s an investment or anything else, that align with their values,” says Jon Hale, Morningstar’s global head of sustainability research. “The idea that you should somehow be able to wring that out of people’s decision-making so that they’re just these purely rational profit-seeking beings, it’s not realistic.”

The ESG (R)evolution. The original ESG—or socially responsible investments, as they were once called—had values-based objectives that excluded certain industries in their entirety for ethical reasons. The **Pioneer** fund (PIODX) started excluding “sin” stocks in alcohol, tobacco, and gambling in the 1940s. Pax World—today known as **Pax Sustainable Allocation** (PAX-WX)—was founded in 1971 by two United Methodist ministers who opposed the Vietnam War and wanted

ESG Defined in 3 Buckets

Investors can choose among funds that exclude certain industries, funds that pick relative ESG leaders, or custom portfolios.

Fund / Ticker	1-Yr. Return	5-Yr. Return	Expense Ratio	Comment
Exclusionary ESG				
Ave Maria Rising Dividend / AVEDX	3.5%	11.7%	0.90%	Catholic values. No abortion, stem cell research, pornography.
Green Century Balanced / GCBLX	-4.8	8.1	1.46	Balanced stock/bond fund. No fossil fuels, GMOs, weapons, nuclear.
Parnassus Core Equity / PRBLX	-2.4	13.8	0.82	Excludes fossil fuels, tobacco, nuclear, gambling, alcohol, weapons.
Pax Large Cap / PAXLX	-3.1	15.0	0.97	Excludes fossil fuels, tobacco, weapons.
Vanguard ESG US Stock / ESGV	-5.4	N/A	0.09	Excludes fossil fuels, alcohol, tobacco, weapons, gambling, pornography, nuclear.
Relative ESG				
DFA US Sustainability Core 1 Portfolio / DFSIX	-4.1%	13.2%	0.18%	Valuation sensitive. Focuses on reducing greenhouse-gas emissions.
Fidelity US Sustainability Index / FITLX	0.1	13.9	0.11	Mostly relative. Replicates the MSCI USA ESG Leaders Index.
Humankind US Stock / HKND	3.7	N/A	0.11	Relative. Selects top 1,000 U.S. stocks with most positive impact on humanity.
iShares ESG Aware MSCI USA / ESGU	-2.4	13.5	0.15	Mostly relative. Replicates MSCI USA Extended ESG Focus Index.
Nuveen ESG Large-Cap Value / NULV	1.0	9.9	0.25	Tracks the TIAA ESG USA Large-Cap Value Index. Uses MSCI research.
Custom ESG				
Fidelity Managed FidFolios	N/A	N/A	0.40%	Two industry or five stock exclusions. ESG index option. \$5,000 minimum.
Parametric Custom Core Equity Account	N/A	N/A	N/A*	Numerous custom screens. \$250,000 minimum. Fees negotiated privately.

Note: Returns through May 27; five-year returns are annualized; N/A=not applicable. *Parametric’s fees are negotiated by account size and customization level. Sources: Morningstar; money managers

to exclude defense-company stocks.

For many exclusionary ESG investors, achieving their financial goals with a clean conscience is more important than maximizing performance. “There are a lot of clients who will say, ‘I don’t care if I underperform [with ESG],’” says Denver-based financial advisor Lynn Dunston of Moneta Group. “‘At least I can go to sleep at night and feel good about my portfolio.’” He has clients asking to exclude gun makers, defense contractors, tobacco, oil, Russia, and opioid makers. Exclusionary ESG funds such as **Pax Large Cap** (PAXLX), **Parnassus Core**, and **Green Century Balanced** (GCBLX) can work here.

While the default assumption is that ESG investors are liberal politically, there are faith-based asset managers and funds that seek to achieve social goals by excluding companies and industries from their portfolios. Catholic-themed **Ave Maria Rising Dividend** (AVEDX), which excludes companies associated with abortion, is one example.

Relative ESG. A newer breed of ESG managers don’t believe in values-based exclusions. Rather, they rank companies in each industry for ESG risks and invest in the best-rated ones. For the most part, this kind of ESG isn’t about “goodness,” but rather sees ESG in traditional financial terms of risk and reward.

MSCI, an ESG ratings service, employs such relative rankings. “Our ESG ratings...are not a general measure of corporate ‘goodness,’” says spokesperson Julie Mansmann. “MSCI’s ESG ratings focus on financial risks to a company’s bottom line in order to help institutional investors...deploy capital in ways



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that maximize investment return.”

Confusing matters: ESG ratings services such as MSCI and Sustainalytics can have very different ratings on the same company, which lead to different performance results from ESG-screened portfolios. The iShares ESG Aware MSCI USA, the largest ESG ETF, uses MSCI’s relativistic ratings. The fund does make some minor exclusions, such as tobacco stocks, but mostly it invests in the best-rated companies in each industry. That includes energy stocks, which account for 4.8% of its portfolio—an identical weighting to the S&P 500 index’s.

S&P Dow Jones Indices recently excluded **Tesla** (TSLA) from its S&P 500 ESG Index while keeping Exxon

for relative reasons, saying in a blog post that Tesla “has fallen behind its peers when examined through a wider ESG lens.” That single example of excluding the most prominent electric-vehicle maker from an ESG index has been a recent rallying cry for investors.

There is, however, a strong ethical case to be made for relative ESG. Many relativists claim divestment of industries doesn’t work to change companies’ behavior. Instead, they support the idea of owning problem companies and advocating for improvement through engagement with management.

Justina Lai, chief impact advisor at wealth manager Wetherby Asset Management, employs a relative

strategy for such reasons. “In general, we encourage our clients to avoid wholesale divestment...Instead, we encourage our clients to retain their seats at the table and utilize shareholder engagement and their voting rights as key levers for changing corporate policy.”

Whose values? For some investors, no ESG fund will conform to their particular values or goals. This is where the third type of ESG investing—custom ESG—becomes so important. It allows individual investors to customize their portfolios to whatever ESG-related values they think are most important. They can leave out whatever sectors they choose, so long as they understand the potential tracking error from conventional benchmarks that may result.

Moneta’s Dunston employs Parametric’s customized direct-indexed accounts. Parametric offers a detailed menu of 52 possible ESG-exclusionary screens that clients can tick off—from “Animal Welfare” to “Workplace Discrimination.” It also offers investors the option to engage with companies via shareholder resolutions.

Unfortunately, Parametric’s minimum account size is \$250,000. However, newcomers to direct indexing can open accounts as small as \$5,000 with Fidelity’s Managed FidFolios, launched in April. The customization is much more limited at FidFolios—only two industries or five stocks can be excluded—but it’s enough to home in on areas that many ESG investors find problematic. FidFolios fees are 0.40%, about average for direct accounts. That’s about half that of the typical actively managed fund, a fact ESG’s critics routinely ignore.

Some custom investors not only want to eliminate problem companies but also invest in companies that are making a positive impact. “That’s the hardest [ESG request],” Dunston says. Targeted funds focusing on wind and solar exist, but court risk due to their lack of diversification. High-net-worth investors and institutions can also use private-equity funds to make direct investments in businesses that seek to combat inequality or serve disadvantaged communities.

Are all of these custom solutions just a “feel good” distraction from taking more meaningful societal action to solve global problems, as some critics say? Hale and other proponents think investors can walk and chew gum at the same time. They can invest in ESG, vote in elections, and be politically and socially engaged.

ESG might be thought of as the equivalent to organic food to such investors. It doesn’t solve the world’s problems by itself, but it can be a small part of a larger solution. ■