LVW ADVISORS

RESPONSIBLE INVESTING: DOING GOOD WHILE DOING WELL

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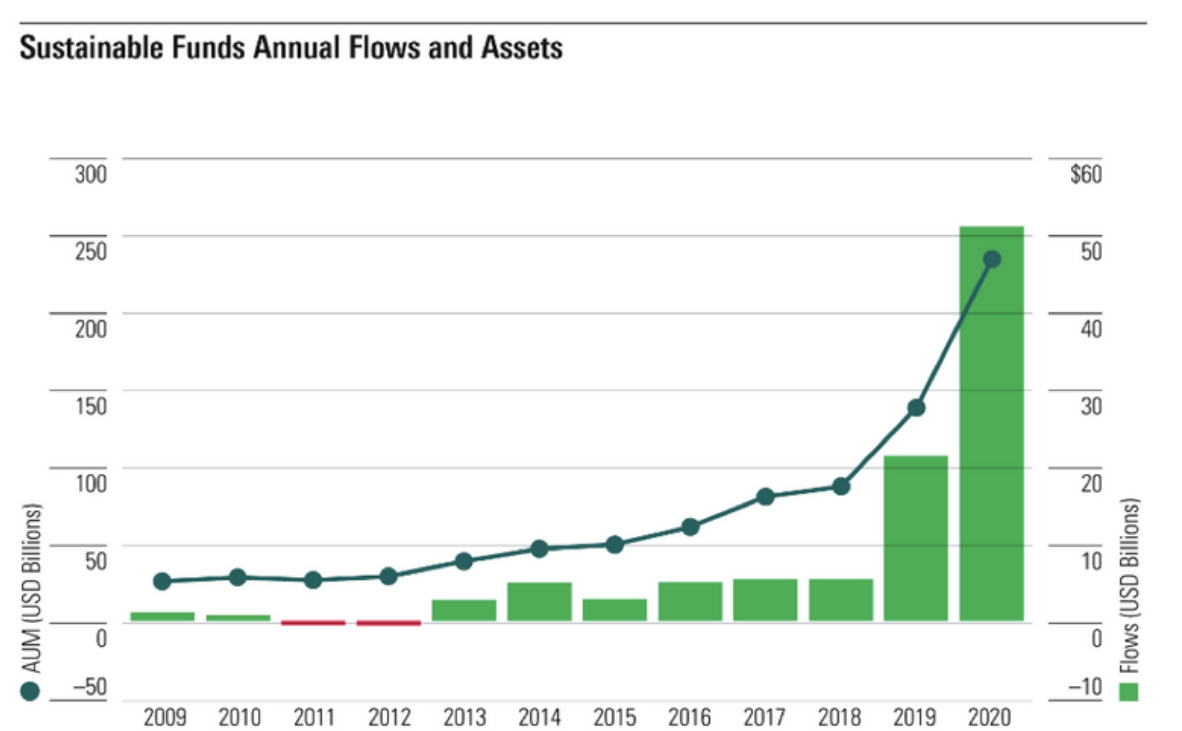
OVERVIEW

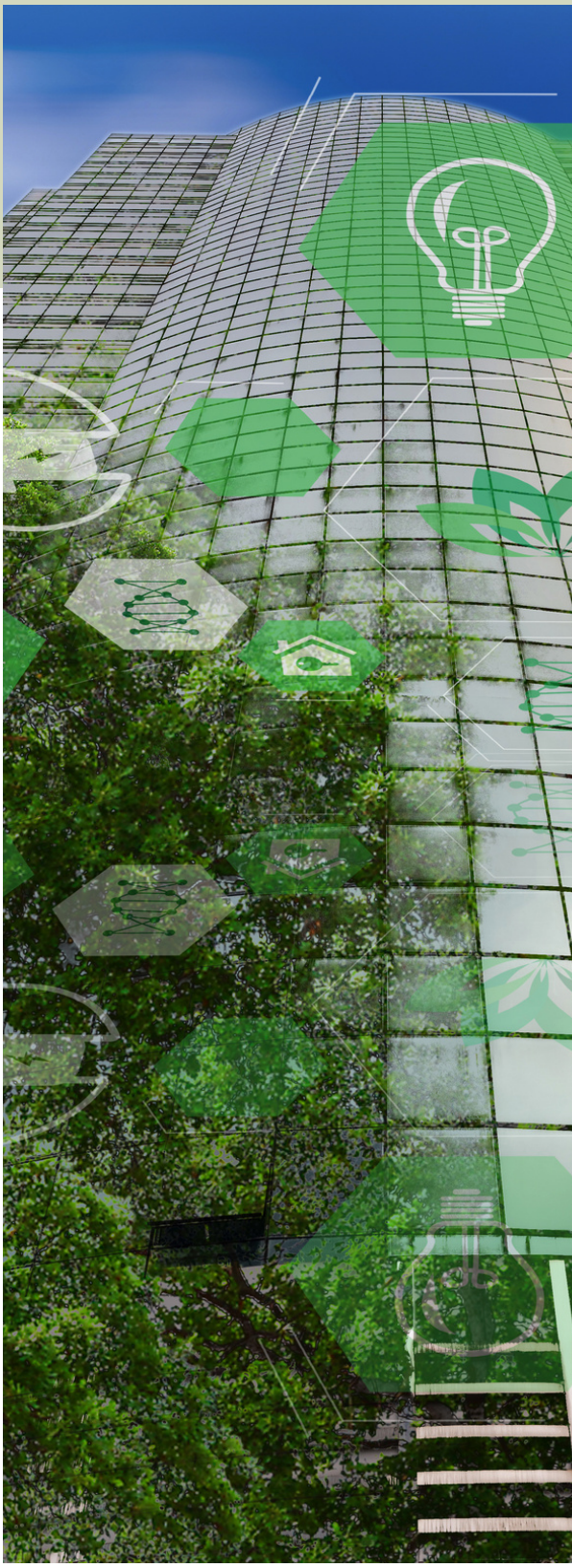
The topic of Responsible Investing has recently garnered a lot of attention. While it may be referred to by various names, such as Socially Responsible Investing (SRI), Environmental, Social and Governance (ESG), Diversity Equity and Inclusion (DEI), Sustainable Investing or others, we believe all of these references belong under the broader heading of Responsible Investing.

While the concept has been around for many years, the pandemic and social climate have brought greater attention to these investment strategies. In fact, Morningstar reported that by the end of 2020, the number of sustainable funds available to U.S. investors was up 30% from 2019, with a nearly fourfold increase over the past 10 years.



Source: Morningstar. Data as of 12/31/2020.
Includes Sustainable Funds as defined in Sustainable Funds U.S. Landscape Report, Feb. 2020.
Includes funds that have been liquidated; does not include funds of funds.

INTRODUCTION



Lori Van Dusen and members of the LVW team began serving institutional and high net worth clients more than 30 years ago. During the early years, when building our clientele as part of a retail brokerage firm, we experienced firsthand the troubling issues that often resulted from a lack of equality, diversity, and inclusion. Attention to these issues, now an integral part of our culture, has long been embraced by our team as we've worked to select investment managers that have the same value system.

Over the years, we have seen an evolution from strategies that were primarily geared around excluding objectionable exposures to strategies that are forward looking and focused on being an agent of change. Today we employ multiple managers that are specifically oriented toward ESG investing, regularly contacting all our managers to understand how they view the subject of Responsible Investing, both in their investment selection as well as their management policies and procedures.

We also work with many of our clients to help them build consensus around what issues are most important to them and to educate them as to some of the opportunities and pitfalls.

We think it is particularly important to identify the issues that are important to you as an individual or organization. Responsible Investing covers a multitude of topics, and not every organization and individual will prioritize the various issues in the same way.

DIFFERENT WAYS TO APPROACH RESPONSIBLE INVESTING

Though there are many ways in which a client can reflect their views within their portfolio, we generally observe three main ways in which investors approach the topic.

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DIVESTMENT

The simplest approach is to identify issues that conflict with your view or mission and avoid any investments in these areas. This is often referred to as a divestment strategy, Responsible Investing, or SRI. This approach has seen some notable effectiveness historically in places like South Africa and Sudan, which are ushering in a new era of social and political change. This approach can also have drawbacks, particularly when applied uniformly to broad segments of the markets. If an investor was to completely divest from companies involved in the extraction of fossil fuels, for instance, this could compromise overall portfolio performance. For example, during the first quarter of 2021, the energy sector of the S&P 500 was the best performing segment, up more than 30%, while the S&P was up just over 6%.[1]

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PROMOTING AGENTS OF CHANGE

A more nuanced approach is to seek out those companies that are actively engaged and seeking to improve upon a particular issue. These strategies are referred to as environmental, social and governance or ESG strategies. Unlike simple divestment, these strategies may invest directly in alternative sources. In the energy space, that may include wind, solar, or nuclear power. By investing in these companies, an investor could reduce the exclusionary impact of completely avoiding an entire segment, while still aligning their investments with their views.

That said, one must also be conscious of the potential unintended consequences. For example, promoting investment in solar companies may have negative human rights implications, as a critical component in solar panels comes almost exclusively from a region in China that is under scrutiny for its treatment of the labor force.

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ENGAGEMENT

In addition to divestment and/or proactive investment strategies, we believe that engagement with the managers and companies can also play an important role in communicating an investor's view. As part of our process, we reach out to the managers within our portfolios to discuss their governance and hiring/recruiting practices. While we are certainly not alone in this practice, we can earnestly say that we have seen some change. Managers are becoming much more aware of these issues and the preferences of their investors.

IMPACT INVESTING: MISSION DRIVEN AND PROGRAM RELATED

Many not-for-profit organizations, and particularly foundations, have the ability to utilize grant making to further their impact. There are two main categories for these types of investment.

Mission-driven investments are opportunities which are linked to an organization's mission and seek to achieve an economic return in line with market rates.

Program-related investments, on the other hand, are made primarily to achieve a program objective rather than a significant financial return.

While both mission-driven and program-related investment opportunities are available in virtually every segment of the capital markets, they are often privately structured and illiquid. Additionally, if a foundation is seeking to utilize these investments as part of their required annual 5% distribution, certain Internal Revenue Service (IRS) requirements must be met.

One advantage of these investments is they create the potential for a compounding effect, as the returns from previous investments can be utilized again for even higher levels of program-related investments. Additionally, since they are often more singularly focused, the impact can be more easily monitored and measured.

SCORING SYSTEMS

As investors' interest in Responsible Investing has increased, there has been an increasing need to measure the various potential issues, the extent to which a company is exposed to them, and how they are addressing that exposure. LVW Advisors continues to work to improve our capabilities in that regard and to leverage the open-sourced research approach that is at the bedrock of our investment research process.

We continue to invest in our analytical capabilities and have access to Responsible Investing data sources that allow us to bring our clients an ever-increasing level of analysis and customization that we believe is critical to helping them achieve their investment goals.

Many providers are now also producing a proprietary ESG score. On the surface, this may appear to be a helpful way to compare investment options; however, we would caution investors to make sure they understand the methodology and limitations involved in deriving this scoring.

In Responsible Investing, as in all aspects of investing, focusing too closely on any one singular statistic or measurement point can often lead investors astray. To combat this effect, we utilize a mosaic approach whereby we combine a broader array of measurements and analyses in an effort to provide our clients a clearer view of the whole picture.

POTENTIAL PITFALLS

While ensuring alignment between an organization's mission and their investment portfolio is an important element of achieving the broader organizational goals, we believe there are also a number of potential pitfalls that investors should keep in mind. Many issues may initially seem straightforward but are often more nuanced than they appear.

Particularly when considering more environmentally focused factors, investors can potentially neglect important segments of the economy.

Additionally, investors should be aware that there may be embedded biases in a broad-based approach to Responsible Investing. For example, industrial companies tend to have a larger carbon footprint simply due to the nature of their business, while technology companies tend to have a smaller carbon footprint. Thus, a well-intentioned investor seeking to invest their portfolio toward a greener economy may find themselves with a significant but unintended overweight to technology.

In the most recent NACUBO-TIAA Study of Endowments, the most cited barrier to Responsible Investing reported by endowments was a concern related to adverse impacts on investment performance. We believe that when done properly and integrated throughout an investment process, one does not necessarily need to sacrifice returns to invest in a more responsible way.

To that end, there have been a number of papers published citing recent market performance as evidence that this is the case. Given the potential sector biases noted above, and the fact that over the past 10 years the Russell 1000 Growth Index has almost doubled the performance of the Russell 1000 Value Index, we would caution investors to evaluate these claims critically.[2] Furthermore, investors should be aware of all of the fees that managers are charging. Responsible Investing is, by its nature, an active management strategy and often carries with it elevated fees.

As is often the case when there is an increase in investor interest, sophisticated marketers will seek to position themselves to meet that increased interest.

In some cases, this is by creating new products that seek to meet that demand. In other cases, it may not be anything new at all, but rather a spin on the presentation of a company or fund that is more in line with the new demand. In the Responsible Investing world, this is referred to as greenwashing. While many of these funds may indeed be in line with investors' preferences, we believe it is important to look deeper to truly evaluate how a manager is responding to these issues and how important they are in their decision-making process.

CONCLUSION

Regardless of what you call it, we believe that aligning your investment portfolio with your organization's views has always been an important part of achieving your investment goals. For both organizations and individuals, investment assets do not exist as an island unto themselves. They are an integral part of how investors will achieve their broader goals, and as such, reflecting those views in your portfolio is only natural.

That said, the issues involved are often complex and imprecise. The factors identified as most important are unique to each family and institution that we work with. To that end, we have worked to develop considerable expertise in bringing clients to consensus around these complex issues, and we welcome the opportunity to explore this issue further with you or others that may benefit from that experience.

SOURCES

1, 2 Bloomberg LLC.

DISCLOSURE

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