Responsible investing: Signs of a growing opportunity?

Investments that pair social and environmental impact with performance are gaining ground and winning investors over. Advisors can play a pivotal role—if they can start to see the forest for the trees.

Key Points

As more people look to align their portfolios with their values, responsible investing offers advisors a growing opportunity to demonstrate their expertise to clients and offer value that resonates with investors on a personal level. But, to fully leverage this momentum, advisors must understand how to evaluate environmental, social, and governance security options—and be able to educate clients about how to integrate them into portfolios.

What is responsible investing?

Responsible investing is broadly understood as a discipline that promotes financial and nonfinancial rewards. It has evolved significantly and recently become more accessible to mainstream investors looking to make a social impact while earning a return.

Responsible investing encompasses four main strategies, with increasing levels of complexity:

- Socially responsible investing (SRI): Investments align social values with performance. This generally screens out companies that do not meet explicit SRI criteria.
- Environmental, social, and governance (ESG) investing: Investments consider ESG criteria to determine a firm's ethical impact, sustainability, and future financial performance. Some examples of ESG factors are pollution, human rights, and conflicts of interest.

- Impact investing: This type can include both public and private equity and debt investments, and it prioritizes a positive impact in pursuit of ESG objectives as much as the financial return. An example is reducing the negative effects of business activity on the social environment.
- Active ownership: Shareholders are allowed to push for improvements through voting and proposals.

Dispelling myths

1. Responsible investments underperform.

There is a misconception that responsible investments don’t perform as well as those without such parameters. The reality is that many responsible investing funds keep up with and at times exceed the performance of traditional funds. For example, the MSCI KLD 400 Social Index averaged an annual rate of return of 13.1% for the 10-year period ending December 2018, right in line with the S&P 500 Index’s 13.1% return over the same period. Schwab analyzed the performance of socially conscious funds in 3-, 5-, and 10-year increments and found they were in line with and sometimes better than the performance of non-socially conscious funds.[1] And additional Morningstar data shows that on average SRI mutual funds have slightly outperformed their non-socially conscious counterparts in the short, medium, and long terms.

Source: Charles Schwab Investment Advisory, Inc., with data from Morningstar, as of December 31, 2018. Returns represent the average annualized performance of U.S. equity open-end socially conscious and non-socially conscious mutual funds. **Past performance is no guarantee of future returns.** The number of socially conscious funds with three-year returns is approximately 316, compared with over 6,500 non-socially conscious funds. Morningstar defines funds as socially conscious if they invest according to noneconomic guidelines such as environmental responsibility, human rights, or religious views.

In 2015, a group of Harvard University researchers studied the impact of corporate sustainability investments on stock returns. They found that companies with good performance on sustainability issues significantly outperformed those with poor sustainability track records. In their assessment, they wrote: "The results speak to the efficiency of firms' sustainability investments, and also have implications for asset managers who have committed to the integration of sustainability factors in their capital allocation decisions."[2]

2. Responsible investments are not affordable.

Another misconception is that individuals need to pay more to invest responsibly. This may have been true decades ago, but these types of funds have become more competitively priced. Out of the 395 mutual funds that Morningstar identifies as "socially conscious," over half (53%) had expense ratios that were lower than their category's average.[3] Morningstar found that "sustainable funds in the U.S. are competitive on price"[4]on the whole.

3. It's too complicated.

Many investors see a puzzle of issues to navigate and understand—and they're right. Because few regulations govern what funds can be categorized as a socially responsible investment, investors could end up supporting activities they oppose. For example, some fund companies have simply recategorized existing products without changing their underlying process or holdings.[5] And then there's the industry jargon. Terms like "exclusionary approach" are prevalent when simply saying "screening out companies" conveys the same point in a more understandable way.

For reasons like these, financial advisors have been slow to adopt. Kelly Brush, manager of advisor relations at Parnassus Investments in San Francisco, says, "Advisors may face the same issues as investors. Some just aren't yet comfortable speaking to their clients about responsible investing."

The answer is education, and the good news is that it's getting easier, says Brush. The availability of reliable educational resources and practical tools for evaluating ESG factors is growing; and there have been great strides recently in regulation, data collection and reporting.

What were once real barriers are now becoming surmountable. With recent developments, advisors can start to see the forest for the trees.

Responsible investing resources:

The Forum for Sustainable and Responsible Investment (USSIF.org): Resources for developing sustainable, responsible, and impact investing expertise

Global Impact Investing Network (thegiin.org):Information, tools, and resources for making and managing impact investments

Principles for Responsible Investment (unpri.org): Tools for analyzing investments along ESG standards across asset classes

Sustainability Accounting Standards Board (sasb.org): Industry-specific standards to assist companies in disclosing financially material, decision-useful sustainability information

Climate Bonds Initiative (climatebonds.net): List of bonds that are certified as "green"

Growing recognition and adoption

New regulations are contributing to the growth of responsible investments, strengthening the ability of asset managers and institutional investors to take sustainability into account. For example, the U.S. Department of Labor ruled in 2015 that ESG factors may be part of the economic analysis of investments made by managers of 401(k) accounts and pension funds.[6] And in March 2018, the European Commission laid out an action plan for new guidelines governing "green" investments.

These new regulations come as public companies are deriving more of their value from intangible assets—those that aren't physical in nature but still generate an economic benefit, such as goodwill, brand recognition, and intellectual property.

A 2015 analysis of S&P 500® companies found that 84% of market value is attributable to intangible assets, up from just 17% in 1975.[7] Christina Alfandary, managing director of ESG & Sustainable Investments at Gabelli Funds, notes, "If the majority of a company's public market valuation is now attributable to intangible assets, an expanded set of metrics and inputs are needed to value the company. Many measures fall within ESG issues and help provide insight into brand, culture, human capital development, and reputation, which in turn sustain the company's performance."[8]

Traditional valuations need to adjust for today's risk landscape. Companies are expected to manage potential threats that include data handling and professional conduct breaches. Nuveen's Annual Responsible Investing Survey, a trended analysis of key issues facing advisors and investors, found that security was a top priority for high-net-worth investors this year, with "higher performance by managing risk" topping "aligning with values" for the first time.[9]

Traditional valuation models like discounted cash flow can help assess financial risks but fail to capture the big picture. Using alternative data sets that account for ESG factors may help catch risks that other analyses can overlook.

One example of the benefits to looking beyond traditional valuations goes back to August 2016, when MSCI ESG Ratings called out Equifax's vulnerability to "data theft and security breaches," downgrading it to CCC–its lowest possible rating. In December 2016, the credit reporting company was excluded altogether from the MSCI ESG Leaders Index. Unfortunately, this security concern was validated less than a year later, when Equifax fell victim to a cyberattack that potentially affected 143 million U.S. consumers.

New regulations, increased market value of intangible assets, and the changing risk landscape all point to a fundamental shift in the types of factors investors and institutions consider, value, and prioritize—many of which are ESG factors.

Younger investors and women are driving growth

Along with improved access and interest, the perceived value to investors of responsible investment is growing. Since 1995, when The Forum for Sustainable and Responsible Investment (US SIF) began researching SRI, U.S. assets in sustainable, responsible, and impact investing strategies have grown from $639 billion to nearly $12 trillion at the outset of 2018, representing an 18-fold increase and a compound annual growth rate of 13.6%.[10] The start of 2016 to the start of 2018 saw a 38% increase in assets under management. Today these strategies collectively account for one in four dollars under professional management in the United States.[11]

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The market's overall rise has also contributed to that growth, as funds meeting ESG criteria continue to expand. For example, the number of ETFs more than doubled between 2016 and 2018.[12]

Asset managers are helping lead the charge. Global investment manager Nuveen says that demographics play a large role in the growth. A 2018 U.S. Trust study showed that 4 in 10 high-net-worth investors—including 77% of millennials and 59% of Gen Xers—either own or are interested in impact investing. A higher percentage of millennials than any other generation currently own impact investments, increasing by 9 percentage points over the past two-year period.[13]

Meanwhile, the same study shows that women are at least 10% more likely than men to be interested in or to own impact-based investments. Men are showing signs of catching up, though. While ownership of ESG investments has remained relatively flat since 2016 (inching upward), interest continues to increase among men, Gen Xers, and even baby boomers.

With an estimated $30 trillion in wealth primed to be transferred during the next three decades, younger investors and women may have an increased influence on investment decisions.[14]

Where do advisors come in?

Nuveen, a subsidiary of TIAA, says that for many individuals, awareness and education are key to removing barriers to access—and this is where advisors can play a role. Recent TIAA surveys show that investors are 74% more likely to work with a financial advisor who gives competitive returns from investments that make a positive impact on society. And, 69% say they are more likely to stay with a financial advisor who can discuss responsible investing with them.[15]

Rachel Robasciotti, a San Francisco–based advisor started her firm, Robasciotti & Phillipson, at age 25. She built her practice around the idea of a "true return"—one that includes the personal financial return clients need and the social return they want. "The idea of a true return is new to our industry, and the fact that our firm is deeply aligned with it is something that clients tell us all the time makes the difference," she explains.

Robasciotti is part of a cohort of advisors who view responsible investing as a way to give a voice to people who feel increasingly passionate about voting in support of their values—people who have been disengaged or traditionally hard to reach. She believes that money can be a powerful change agent.

But leveraging the responsible investing opportunity doesn't require a wholesale change in business strategy. Instead, it's a matter of applying advisor expertise to new subject matter and becoming confident and educated. It is a way to offer personal value to clients who want to see their investments align with causes they believe in—and can help differentiate the advisor relationship.

Getting started with responsible investing

At Schwab's IMPACT® conference, Nuveen outlined five steps advisors can take to begin implementing responsible investing:

1. Understand the demand. Make yourself familiar with the growth in assets and availability of responsible investing offerings.
2. Build your knowledge. Get up to speed on responsible investing resources and organizations. Understand acronyms and continuing education opportunities. If anything is a stretch, consider partnering with someone in your community with expertise in the space.
3. Market your expertise. Find ways to introduce this new expertise. Consider outlets such as newsletters, client events, conference calls, or webinars.
4. Connect with clients. Don't wait for clients to inquire about options. Ask them if they do any charitable or philanthropic giving, or if they feel strongly about any social causes or global issues. Follow up by asking if they would be interested in aligning their interests and values with their investments. Be sure to include other family members who may be next in line to make the

decisions. And ditch the jargon. You've gained the expertise so that your clients don’t have to—try to use common language.

5. Integrate into client portfolios. Evaluate the existing holdings, and identify new investment opportunities that align with their interests and values. Employ third-party research providers—MSCI, Sustainalytics/Morningstar, and Bloomberg are all good starting points—to analyze fund composition and performance. Start small with one or two funds so that you and the client can analyze performance, and proceed from there.

Nuveen closed by cautioning advisors against being too prescriptive with any client on the topic of responsible investing: "When you start to speak to your client or prospects about the opportunities or what’s important to them from a responsible investing perspective, go in there with a very open mind, because it can take many different forms."

An avenue worth exploring

The once niche market of responsible investing continues to gain steam and demonstrate a potential to deliver solid, long-term returns. The trend is accelerating as a new wave of investors with deep connections to social and environmental issues reaches its high-earning potential. Even existing clients who haven't expressed previous interest could benefit.

The timing is right for financial advisors to take the lead on helping clients align their values with their financial goals. Advisors who build responsible investing opportunities into their practices are in a position to create a platform for long-term growth that is professionally rewarding and desirable to their clients.

We hope that understanding more about responsible investing provides you with another avenue to connect with clients and prospects. Consult the Socially Conscious Funds Listto find socially responsible mutual funds and ETFs that Morningstar has identified as socially responsible.

If you're thinking about becoming an independent advisor, consider a custodian that invests in your success. Contact us to learn more about the benefits of a custodial relationship with Schwab. Consult the Socially Conscious Funds List to find socially responsible mutual funds and ETFs.

1. Morningstar Direct, as of December 31, 2018.

2. Mozaffar Khan, George Serafeim, and Aaron Yoon, "Corporate Sustainability: First Evidence on Materiality," Harvard Business School Working Knowledge, March 24, 2015.

3. Michael Iachini, "Socially Responsible Investing Comes of Age," Insights & Ideas, Charles Schwab, February 1, 2019. Morningstar Direct, as of 12/31/2018.

4. Jon Hale, Sustainable Funds U.S. Landscape Report, Morningstar, January 2018.

5. Jon Sindreu and Sarah Kent, "Why It's So Hard to Be an 'Ethical' Investor", The Wall Street Journal, September 1, 2018.

6. "Interpretive Bulletin Relating to the Fiduciary Standard Under ERISA in Considering Economically Targeted Investments", Federal Register, Vol. 80, No. 26, October 26, 2015.

7. Intangible Asset Market Value Study, Ocean Tomo, 2015.

8. Christina Alfandary, The Investment & Business Case, ESG Investing, Gabelli Funds, 2016.

9. Fourth Annual Responsible Investing Survey, Nuveen, 2018.

10. Report on US Sustainable, Responsible and Impact Investing Trends 2018, The Forum for Sustainable Responsible Investment.

11. Ibid.

12. Ibid.

13. 2018 U.S. Trust Insights on Wealth and Worth®, U.S. Trust, 2018

14. The "Greater" Wealth Transfer: Capitalizing on the Intergenerational Shift in Wealth, Accenture, 2015.

15. Second Annual Practice Management Study, TIAA Global Asset Management, 2016.

Past performance cannot guarantee future results.

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Socially screened funds exclude certain investments and therefore may not be able to take advantage of the same opportunities or market trends as funds that do not use social screens.

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