The Responsible Investing Penalty: Myth or Reality?

by David Zellner

ESG is gaining momentum and maturing into the focal point of today's socially responsible investing (SRI) movement. An acronym for environmental, social and governance issues, ESG plays a vital role in the larger picture of corporate responsibility and sustainability. Increasingly, institutional investors around the world understand how ESG analysis contributes to both investment performance and long-term company sustainability.

In a somber reassessment of the 2008-2009 financial crisis, one conclusion is clear: business decisions driven only by a narrow focus on profits led to unwise – and unsustainable – practices within the financial services industry.

Looking back over recent decades, examples of the same shortsighted thinking – inflicting similar damage – can be found across all industries. Some investors have come to recognize that responsible investing can not only have a positive impact on corporate business practices, but also enhance investment returns.

Two widely recognized approaches to responsible investing include screening out companies because of their undesirable products and services, and integrating consideration of ESG principles into the investment process. While the impact of the first can be monitored and measured, weighing the effects of the second is more difficult and generally requires more time to assess outcomes. Wespath closely monitors and evaluates the impact and potential impact on return of its screens.

We are, first and foremost, a fiduciary. We have an obligation to make a "conscious effort" to align our investment program with the values of the Church and ensure that whatever screening we do is consistent with the principles of prudent investment management. Hence, considerable discussion will occur among the Wespath management team and the board of directors to make certain that existing screens and any new ones do not violate our fiduciary obligation to our clients and participants.

Dave Zellner

Mr. Zellner is the chief investment officer of Wespath, a division of the General Board of Pension and Health Benefits (General Board) of The United Methodist Church, and is responsible for executing and administering Wespath's investment program. He has been with the General Board since 1997. In 2006, he was a co-author and an original signatory of the United Nations Principles for Responsible Investment, a global landmark in responsible investing.

When we look at past performance, we can demonstrate that screening generally has not adversely affected our funds' investment performance. The data in the chart below shows that, in nearly all cases, the impact of screening on returns has been *minimal*. Various studies of the effects of screening on investment performance have reached differing conclusions; however, there is an ample body of independent analysis indicating that screening has had little adverse impact.

Figure 1
As of 12/31/2010

Mandate[1]	Period (Yrs)	Wespath	Composite[2]	Difference
U.S. – All Cap Core	35.0	11.63%	12.25%	–0.62%
U.S. – Large Cap Growth	24.6	10.61%	10.55%	+0.06%
U.S. – S&P 500 (Passive)	22.5	9.27%	9.43%	–0.16%
Non-U.S. Developed	20.7	8.88%	8.84%	+0.04%
U.S. – Small Cap Growth	16.6	14.43%	14.48%	–0.05%
U.S. – All Cap Growth	16.4	10.56%	10.53%	+0.03%
Non-U.S. Emerging	13.8	10.44%	11.15%	–0.71%
U.S. Russell 3000 (Passive)	13.0	4.21%	4.26%	–0.05%
U.S. Russell 1000 Value (Passive)	12.1	4.02%	4.16%	–0.14%
Non-U.S. Emerging	11.6	17.43%	17.15%	+0.28%
U.S. – Mid Cap Growth	11.0	5.50%	5.34%	+0.16%
U.S. Russell 2500 Value (Passive)	9.8	8.58%	8.62%	–0.04%
Non-U.S. Small Cap	9.3	14.35%	14.52%	–0.17%
U.S. – Small Cap Core[3]	8.6	5.48%	4.67%	+0.81%

All Wespath and composite data represent compounded annual rates of return over the indicated period for the specified mandate.

Source: The General Board of Pension and Health Benefits of The United Methodist Church

[1] The mandates above represent specific strategies included in the U.S. Equity Fund and International Equity Fund. They each represent a strategy continuously managed for the specified period by an external investment manager engaged by Wespath.

[2] Composite represents the compounded annual rate of return for the aggregate of all the similarly managed non-screened portfolios managed by the asset manager.

[3] Data through 12/31/2009.

Figure 1 compares the performance of Wespath portfolios against the composite performance for each manager's non-screened portfolios. Looking at the S&P 500 passively managed mandate, this benchmark is screened for alcohol, tobacco and other exclusions versus the unscreened S&P 500 Index. For the 22-year period, the portfolio underperformed the unscreened S&P 500 by 0.16 percent – a fractional and insignificant difference, especially given the fund's adherence to principled investing throughout the period. Another example may be found in Large Cap Growth, indicating that over a period of 24 years, the portfolio returned 10.61 percent versus 10.55 percent for all of the manager's other accounts. Once again, this is an insignificant difference and leads us to conclude that the screens did not hinder performance. While the difference for the longest relationship shown by the table is an average annual underperformance of 0.62 percent, closer analysis reveals that the difference is primarily attributable to the early part of the period when we honored restrictions on investments in South Africa. Over the past 10 years, however, the performance difference for this mandate relative to the composite of non-screened portfolios is insignificant.

Additional industry data generally confirms that investors are not required to give up return with portfolios that screened based on various criteria including ESG considerations. The MSCI KLD 400 Social Index – comprised of 400 companies drawn from a universe of the 3,000 largest U.S. public equities by market capitalization – is designed to provide exposure to the common stocks of companies that have positive ESG characteristics. Since its launch in May 1990, the KLD 400 Social Index has performed competitively, returning an average of 9.62 percent annually through December 31, 2010, compared with 8.96 percent for the S&P 500 Index.

"We were an early leader in the sustainability movement because we thought it was the right thing to do for the environment. But we discovered something else along the way. Every one of our innovations ended up either saving us money or creating new markets and new revenue. We found, in other words, that we don't have to choose between the environment and profit. We can do both."

Ursula M Burns
CEO, Xerox

ESG Factor Analysis Moves to the Forefront

The management of responsible investing strategies has evolved beyond screening companies whose behaviors, products/services or governance practices are considered unacceptable. Analyzing the impact of a company's ESG policies and practices allows for a comprehensive evaluation of risk and is quickly becoming a proxy for determining sustainability. ESG embraces corporate governance, the environment, product safety, workplace standards and other issues. Engagement, proxy voting and the filing of shareholder resolutions are among the tools used by ESG-aware investors to promote more responsible business practices.

Although more difficult to measure, these strategies have proven effective. For example, discussions that we (and others) held with Walmart over many years led to the publication of its first sustainability report. Consequently, the company has embraced a number of environmental initiatives that we believe ultimately will increase shareholder value. Another example is the collaboration with The Walt Disney Company and McDonald's Corporation to improve their monitoring of suppliers' compliance with vendor codes of conduct, particularly as they relate to fair labor practices. This resulted in a groundbreaking approach to compliance that established controls applied across the full spectrum of labor issues.

Many business leaders have acknowledged that engagement with responsible investors regarding corporate ESG policies have positively contributed to more sustainable business practices.

The Impetus Provided by UNPRI

Today, the integration of ESG analysis into the investment process is recognized as a more effective approach. One of the major milestones in the global advancement of ESG analysis as an investment discipline came to be in the 2005 – 2006 period under the sponsorship of the United Nations. Recognizing that shareholder influence was the force with the greatest potential to bring about lasting change, the UN convened 25 public and private institutional investors from the U.S. and around the world to collectively draft basic principles for responsible investment. We were honored to be selected as the only faith-based institution in the world to participate in the development of these groundbreaking principles.

Over a period of several months, we met periodically, communicated continuously, and rose to the challenge of establishing a common language and set of beliefs about the importance of ESG analysis in the investment process. The end result was the UN Principles for Responsible Investment (UNPRI), which asks that signatories actively "promote acceptance and implementation of the Principles within the investment industry." Now, about five years later, the original group of 25 signatories has grown to more than 800 organizations representing $20 trillion in assets. This reflects, I believe, the importance and relevance of ESG as a contributor to better investment decisions.

Growth of ESG-Focused Assets

Further demonstration of the influence and elevated profile of responsible investing, particularly ESG, comes from its growth in recent years. In its 2010 *Report on Socially Responsible Investing Trends in the United States*, the Social Investment Forum states that at the start of 2010, professionally managed assets following socially responsible principles stood at $3.07 trillion, a rise of more than 380 percent from $639 billion in 1995, the year when the report was first published. Over the same period, the broader universe of assets under professional management increased only 260 percent, rising to $25.2 trillion from $7 trillion.

> **"Our approach has created value not only for our stakeholders and society, but also for Intel. We have reduced costs through energy conservation investments, minimized risks by proactively working with our communities and supply chain, and enhanced our reputation as a leading corporate citizen by building trusted relationships around the world."**
>
> Paul S. Otellini,
> *President and CEO, Intel*

ESG Expansion During the Financial Crisis

The period from 2005 to 2010 – which included the 2008 – 2009 financial crisis – saw investors strengthen their commitment to values-based investing. Over this period, assets managed in accord with ESG factors increased 34 percent while the broader universe of professionally managed assets increased only three percent, according to the Social Investment Forum. Over the three-year period from 2007 through 2009, broad market indices, such as the S&P 500, declined and the broader universe of professionally managed assets increased less than one percent. Sustainable and socially responsible assets, however, grew by 13 percent over the period, according to Social Investment Forum data.

A Look Ahead

Despite the growth and global acceptance of ESG factor analysis, there is still work to do. In fact, perhaps the greatest opportunity for continued progress is in the U.S. Many countries throughout the world – including locales such as Australia, Brazil and U.K. – are actually well ahead of the U.S. when it comes to integrating ESG analysis into mainstream investing. Institutions' (and individuals') demand for investments incorporating the analysis of ESG criteria, as well as a more effective regulatory and legislative environment, are just two factors that will lead to accelerating growth in the future.

Another factor is better understanding of the objectives of ESG analysis. Some investors unfamiliar with the UN Principles may assume that signatories are unable to invest in certain companies. But this is not the case at all. The Principles do not preclude investment in companies that have a poor environmental or social record. The Principles simply ask that investors take environmental, social and governance factors into consideration. An investor may recognize the value in a company if it were to address ESG factors in a more sustainable manner. Further, the investor may engage in dialogue or other activities to convince the company to implement more sustainable policies and business practices.

Conclusion

Led by ever-increasing recognition of the value of ESG factor analysis, responsible investing continues to gain momentum. This is occurring despite the lingering myth that suggests there is a return penalty associated with responsible investing. In reality, the mounting body of evidence indicates that investors adhering to social principles are able to capture competitive returns over the long term. ESG factor analysis – embracing dialogue, proxy voting, shareholder resolutions, advocacy and a focus on sustainability – is clearly a growing trend in how investors select and manage assets globally.

If you would like to discuss how your institution can benefit from Wespath's investment philosophy and focus on ESG, please contact Derek Casteel at 1-847-866-4100 or via e-mail at **investmentinfo@wespath.com**.

Wespath provides UMC-affiliated institutional investors with access to well-managed investment programs that historically have delivered competitive performance while honoring United Methodist Social Principles. Wespath is a division of the General Board of Pension and Health Benefits of The United Methodist Church, a century-old institution with a well-regarded reputation for delivering returns aligned with values.

Wespath is an established investment manager with approximately $17 billion in assets under management.

Our name honors John Wesley, the founder of Methodism and a leader in establishing social principles that outline the tenets of socially responsible business practices. Wespath reflects this Wesleyan heritage, along with the idea of putting clients on the right path to financial growth with a commitment to values-driven investing.

Wespath

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