Doing Well by Doing Right

Investing in ESG Funds

A Q&A on environmental, social and governance investing with Brian Sommers, CFA, HBKS® Principal and Chief Investment Officer conducted by Genevieve George, CPA, CFP, CFE, HBKS® Financial Advisor

I HAVE BEEN SPENDING TIME THINKING about what I would like young investors to know as they begin their investment career. I have asked several of them what they consider important and the same acronyms keep popping up, ESG and SRI investing. I thought it would be helpful to discuss this kind of investment philosophy with our expert, Brian Sommers, Chief Investment Officer and head of our Asset Management Group at HBKS® Wealth Advisors.

GEORGE: Many investors, younger investors in particular, are asking about socially responsible investing (SRI) and environmental, social and governance (ESG) investing. Explain to us how the two are alike and yet different.

SOMMERS: The terms are often used interchangeably, but they are different. SRI goes back to the '60s and was popularized in the '80s. It is about aligning investment decisions with personal beliefs. A lot of people still think in those terms. But there has been a transformation where SRI is being replaced by ESG investing. SRI was based on excluding or including certain companies in a portfolio based on what they make or what they do. An investor might have excluded weapons, liquor, tobacco or gambling companies, for example. ESG investors look for companies that adhere to certain principles. Do they have strong management, a positive working culture, a diverse board of directors? Do they respect human rights and do their best not to harm the environment? It's not so much about what they're making or doing but their corporate policies.

Some SRI investors might not buy an energy company, for example, because they pollute the environment. But an ESG investor might invest in energy companies that are doing better than their peers in limiting pollution, doing their best to create energy in a way that minimizes pollution.

GEORGE: What have been some of the challenges to building these types of portfolios?

SOMMERS: It is very difficult to put together an SRI portfolio that satisfies everyone because each person has their own concerns. One person might be concerned about the environment and another about human rights. One might not want gun manufacturers in their portfolio, another might mostly be concerned about diversity.

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Over time, SRI portfolios haven't performed well in comparison to traditional portfolios. By excluding some of the best performing sectors, they lack the diversification portfolios benefit from historically. What we're seeing with ESG is the exact opposite. Companies with diverse management and boards of directors and positive cultures, with environmentally conscious policies in place, and who care about human rights — they do better over the long run.

GEORGE: How does that relate to the portfolio strategy here at HBKS®?

SOMMERS: We include ESG factors in the extensive screening process we use when we are selecting a manager for a specific asset class. Many SRI investors tended to place more weight on their personal values than performance. The managers we're selecting for the most part adhere to ESG values — and without sacrificing performance. ESG is also an opportunity for active management to add value. If you adhere to this process of figuring ESG factors into portfolio manager selection, you get both better performance and a more socially conscious portfolio than a pure passive index.

GEORGE: What about investors with a specific value they're looking for, like a religious-based or issue-based preference?

SOMMERS: We do our best to address specific requests, but we're not going to invest in a fund or a manager in an asset class whose performance is not at least comparable to the benchmark. Still, usually we can find and substitute an SRI fund. I'm reminded, however, that you can run into trouble by selecting a fund that might appear in line with a particular wish, but with a perspective that the investor doesn't agree with. We've seen where differences in philosophies render a fund unacceptable.

Let's say an investor doesn't like investing in energy. The funds with the most energy stocks are value funds. We'll look to substitute another value fund that is diversified enough and performs well.

GEORGE: What about people with a particular company they believe in or something they want to avoid, like energy stocks?

SOMMERS: Basically people should not place a large portion of their wealth in any one position. That applies as well to investing based on an ESG factor because there are myriad other issues to consider, like cash flow, earnings, and valuation. You need to look at the whole picture, including ESG factors and fundamentals, before you invest.

GEORGE: Would you advise someone to invest in an ESG mutual fund?

SOMMERS: There are ESG mutual funds but they come at the issue in different ways, so you have to drill down to see how they're looking at it. There are a lot of marketing gimmicks out there trying to tap into the sentiment, but that doesn't mean it's a good fund. That's why we perform rigorous research in our selection of managers. We're breaking it down into asset classes — small cap, large cap, and so on — while those other funds may not provide access to classification categories.

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GEORGE: Considering the growing momentum of ESG strategies, what do you say to someone interested in ESG investing?

SOMMERS: Identifying prospective companies to invest in is very difficult for an individual investor. You should talk to your advisor and ensure their process includes screening for ESG factors in their manager selection process. Performance will be better if ESG is part of an overall strategy as opposed to finding funds specifically labeled as ESG. There are screening tools to use to see how a particular manager ranks versus their peers in ESG factors. It's something your advisor should have access to.

As the momentum of ESG investing continues to grow and shape the investing environment, it is important that investors understand the various ESG ratings and how their advisor is incorporating the strategy into their long-term portfolio.

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About the participants:

Brian Sommers oversees the firm's investment management processes for HBKS® investment advisory representatives. He chairs the firm's Investment Policy Committee and is instrumental in the identification, evaluation and recommendation of the investments that make up the firm's client portfolios.

Genevieve George is a financial advisor in the HBKS® Stuart, Florida, office. She has more than 10 years of public accounting experience working with clients in a number of industries. She is also a manager for the firm partner HBK CPAs & Consultants.