A Practical Guide for the Socially Responsible Investor

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Socially responsible investing (SRI) isn't a new phenomenon. The approach has been around since the late 1970s, though it has only gained mainstream acceptance in the past few years. What has fueled its recent hype? In a word, demand.

Just five years ago, professional wealth managers generally viewed SRI as a niche topic — to the extent that many financial advisors avoided broaching the subject with clients and other industry insiders. Misconceptions about its efficacy as an investment strategy and its appeal to investors were rampant, and advisors who had practical knowledge in its application were few and far between.

It's a different story today, with most Americans being conscientious about the companies they support. Consumers increasingly align their spending with their personal values, which benefits brands that openly contribute to environmental change or some other social good. This tendency has also influenced their behavior as investors. Many Americans now view investing as not only a strategy for accumulating wealth but also as a way to impact the world.

As more clients demand financial products that directly or indirectly funnel money toward positive change, the wealth management industry has been forced to evolve to meet that demand. Once these value-driven investors find a cause, however, it's essential that they know the most effective way to contribute to that initiative.

What's Causing All of This?

SRI has become one of the hottest topics among retail investors and financial advisors alike. But is it merely a fad, destined to fade in the months and years ahead? While not everyone is convinced, the following trends provide clues as to why SRI has emerged on the scene — and why its potential staying power is so strong.

Girl Power: A growing number of women are taking a more active role in investing. According to studies by Morgan Stanley and others, women tend to be more interested in topics like sustainable investing. Plus, they generally feel more motivated to invest responsibly than their male counterparts.

Youth Movement: Millennials are wielding more financial power each year, accumulating wealth from inheritances and their time in the workforce. These are the same young people who have forced corporate America to take a stand when it comes to environmental and social issues, and the generation behind them (Gen Z) shows a similar zeal for creating a better world.

Myth Busting: Historically, SRI strategies were criticized based on the belief that they compromised investor returns. As these strategies continue to keep pace with — and often exceed — returns generated by non-SRI approaches, that criticism has all but disappeared.

Product Proliferation: Until recently, a lack of accessible financial products made it difficult to invest according to a certain set of values or a specific sustainability mandate. Now, even novice retail investors have countless options to choose from when sourcing investments that align with their beliefs.

Real-World Impact: Corporate behavior is evolving as a result of changing investor demands. Just look at last year's unprecedented announcement from the Business Roundtable, which includes chief executives from many of the world's leading companies. According to these leaders, corporations have obligations to all stakeholders — not just shareholders and management teams. That's a complete reversal of decades of corporate philosophy, and it's due in large part to the rise of socially responsible investors.

Each one of the preceding trends is still in its nascent stage, which we believe suggests that SRI strategies have yet to reach peak popularity. We can only speculate about how investor interest will grow over time; to forecast where SRI will go, we have to first look at where it is right now.

Taking Center Stage

Based on our observations and insights, SRI is still largely applied as a portion of an individual's broader investment strategy and not the core strategy.

In recent years, however, clients have increasingly been leading value-centric investment conversations that voiced concerns about topics like fossil fuels and opioid use — or expressing interest in private equity impact investing. As such, SRI approaches like environmental, social, and governance (ESG) investing have become a focal point of these conversations.

The fact that a wide array of financial products are available to facilitate responsible investing makes it easier to build a complete and diverse SRI-centric portfolio that can meet any mandate. These portfolios are effective and consistent, which makes them easier to recommend to clients.

Due to the confluence of multiple significant trends, however, SRI is shifting from a "satellite" portfolio component to a core offering of many money management offices. As these trends reinforce one another, SRI philosophies could ostensibly become investing fundamentals.

But they'll have to overcome some major hurdles first.

The Truth About Responsibility

While criticisms of SRI strategies aren't as loud as they once were, they do still have some credence. There are several persistent barriers to implementing SRI approaches successfully, especially for retail investors constructing their own portfolios. Here are some of the big ones:

'Greenwashing'

The Financial Conduct Authority, the U.K.'s asset management regulating entity, defines greenwashing as "marketing that portrays an organisation's products, activities or policies as producing positive environmental outcomes when this is not the case." Now that virtually every company faces heightened scrutiny related to ESG policies, a growing number are attempting to convince investors that their shares are a responsible investment. Digging through this marketing — or finding a financial advisor who can confidently separate fact from fiction when analyzing corporate communications — isn't always easy.

Preconceived Notions

Funds will often choose a name that gives investors some idea of their management philosophies. But names can be misleading. For example, the holdings of a hypothetical "Space Exploration Fund" might include several companies that do indeed contribute to exploring the final frontier — but it might also contain tobacco companies, mining and drilling enterprises, or financial services firms. Investors that make decisions based solely on a fund's name or ratings from mainstream providers like Morningstar are often surprised when they later discover that the fund's mandate doesn't align with their personal values. Evaluating a fund's activities based on real data can be difficult, but it becomes much easier with the help of a specialist.

Diversification Dilemmas

Retail investors attempting to construct their own portfolios around an SRI strategy run the risk of, well, taking on too much risk. For example, ESG funds and those associated with environmental sustainability may be heavily weighted toward large, domestic, growth-oriented technology companies. A portfolio with too much exposure to a single sector, market cap, style, geography, or any other attribute provides little protection during downturns. Investors have to do plenty of homework to ensure that an SRI-focused portfolio is appropriately weighted, and not everyone has the time or experience to construct a properly diversified portfolio.

Lack of Oversight

Many people keep the majority of their investment dollars inside an employer plan — a 401(k) or 403(b), for example — and many of these plans don't offer SRI or ESG investment options. Plan participants need to apply pressure to employers to get these products added to the company investment lineup, and that's a step not everyone is willing to take.

More Money, More Problems

With the threat of inflation looming, some investors will want to explore other strategies that offer a significant hedge. It's somewhat difficult to obtain inflation protection with an SRI strategy because of the destructive environmental nature of oil producers, miners, and other natural resource companies. While these are the stocks that tend to outperform when inflation is high, they generally have poor environmental and human rights records.

Aside from these obstacles, SRI-focused investors face one more challenge that every investor confronts at some point: market volatility.

Keeping Calm

Periods of heightened volatility can test the nerves of even the most seasoned investors. Just ask anyone who's held U.S. stocks over the past few years. Interestingly, SRI strategies tend to outperform during volatile times due to a unique combination of factors.

First, investors whose portfolios are aligned with their deeply held personal beliefs and values often find it easier to focus on the big picture when the short-term outlook seems bleak. This ability is critical to achieving optimal long-term investment performance. Similarly, those who invest in local businesses can rest easier when returns are scarce because they know their money is supporting their community.

From a practical standpoint, analyzing companies based on ESG factors or other SRI-related attributes often leads investors to avoid certain types of businesses that face long-term structural risks (e.g., fossil fuel companies) and gravitate toward those that exhibit good management practices. Logically speaking, strong governance should lead to better financial performance over time.

Finally, SRI strategies often call for direct engagement with portfolio companies. Fund managers can push for positive corporate behavior concerning environmental, social, or governance issues. This ends up allowing investors to feel as though they are creating real change within their portfolio companies. As that change manifests itself in the form of new corporate policies, leadership shake-ups, or other real-world actions, investors may gain confidence that their money is working for them — even when volatility is pervasive.

Answering the Call

A growing number of investors have found that the benefits of SRI-focused strategies outweigh the potential downsides. Moreover, these strategies are abundant and varied enough that even the most discerning investors can find an approach that aligns with their specific goals.

Even so, SRI is not without risk — and is not for everyone. The old maxim that "knowledge is power" is especially applicable in the investing world. Before adopting any SRI strategy, here's what you should know:

1

Know what you believe.

Values-based investing isn't possible if you're not clear on your values. Think hard about the causes and issues that are important to you, and then decide what matters most. You may have to sacrifice other opportunities to align your investments with your beliefs, so take that into consideration as you prioritize your investment goals.

2

Know what you own.

If you haven't yet, evaluate your current holdings to identify potential discrepancies between portfolio companies and your personal beliefs. You shouldn't try to address these discrepancies all at once, though. Instead, reallocate your capital over time to invest in companies that better reflect your values.

3

Know what's available.

There's no shortage of financial products catering to socially responsible investors, but not all of them are good investments. Look for fund managers whose goals align with your own — and who will actively engage with the corporate boards and management teams of their portfolio companies. This will allow you to be more confident that the companies you support are incentivized to act responsibly.

4

Know when to ask for help.

Reflect on your current circumstances while being honest about what you don't know. Not everyone has the expertise or access to data that's required to construct a balanced portfolio of socially responsible investments. If you're not sure whether you can do it alone, reach out to your financial advisor for help. If you don't have an advisor, ask someone you trust for a recommendation. You can then talk to prospective advisors about their experiences building socially responsible portfolios for clients.

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SRI is not a new concept, and it's not going away anytime soon. To get the most out of these values-driven investments, familiarize yourself with the benefits, barriers, and best practices that accompany them. In doing so, you can paint a clearer picture of how your intent to contribute to social change and your goal of improving your finances can work in tandem.

Want to learn more about how Pekin Hardy Strauss Wealth Management helps clients align their portfolios and values? Visit our website to learn more, or give us a call. We're happy to help!

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