The Next Generation of Socially Responsible Investing

It is getting easier for investors to incorporate their personal values into their portfolios and to do so in a diversified, low-cost and tax-efficient manner.

This approach, traditionally known as socially responsible investing, is increasingly being referred to as environmental, social and governance investing—or by its acronym, ESG investing. As its name suggests, ESG investing considers the potential environmental and/or social impact of a particular investment—a concept known as sustainable, responsible and impact investing, or SRI investing.

Growth of ESG Investing

Historically, ESG investing was known mainly for "negative" screening, or excluding certain companies or sectors from a fund or portfolio. (Tobacco and oil stocks are two common examples). ESG investing now commonly includes "positive" screens as well—in other words, actively seeking companies or sectors considered to have "best-in-class" ESG performance metrics relative to their industry peers.

There's been a longstanding perception that screening one's portfolio can have a negative effect on investment performance, as it may result in less diversification. However, an increasing amount of research has countered this notion—particularly for funds that use both positive and negative screens, as opposed to negative screens alone. This was affirmed in a recent meta-analysis. **Jon Hale of Morningstar** reviewed the findings of numerous academic studies and concluded that ESG investors "can receive competitive performance while also addressing their sustainability concerns."

Without a doubt, ESG investing is rapidly evolving from a niche corner of the investment landscape into the mainstream. As Figure 1 shows, a recent study by the Forum of Sustainable and Responsible Investment (US SIF) found that assets held in sustainable, responsible and impact-focused investments now account for $8.7 trillion, or one in every five dollars invested under professional management in the United States. This compares to $639 billion in 1995, when US SIF first conducted its survey.

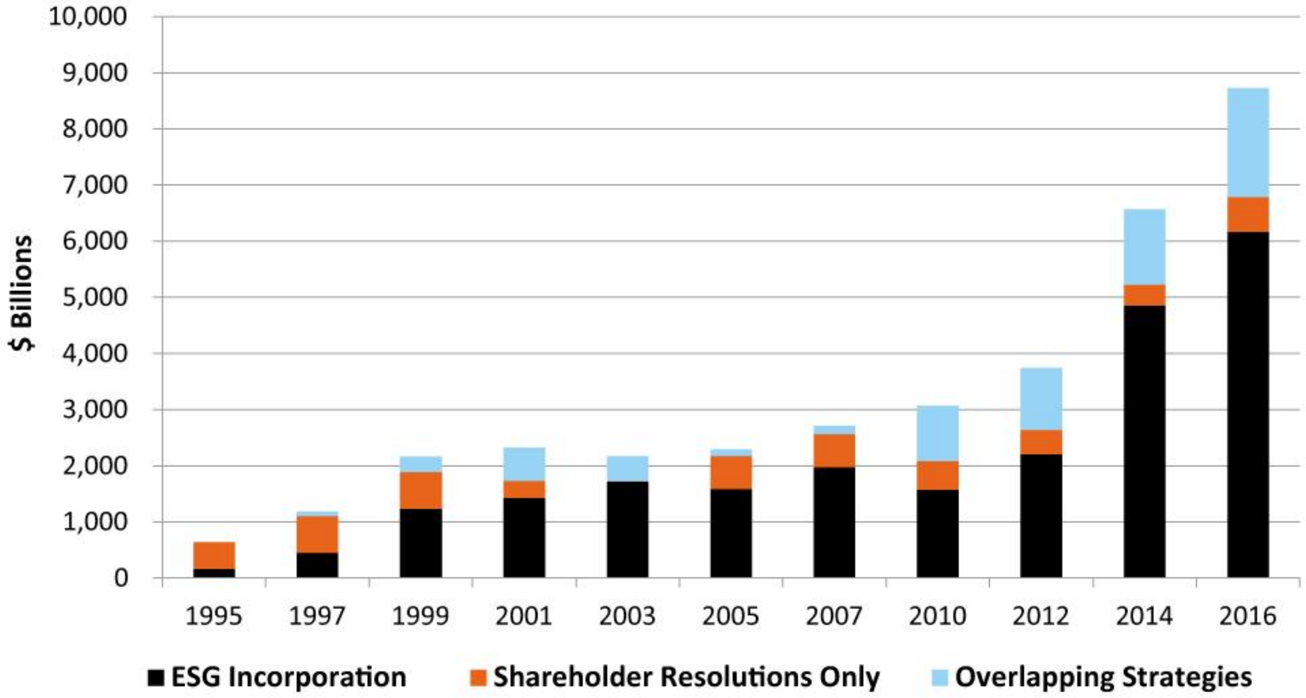

Figure 1. Dollars Invested in Sustainable, Responsible and Impact Investments

Additionally, the field has become quite broad in scope, encompassing not just screened funds but shareholder advocacy, community investment (deposits at banks, credit unions and other financial institutions whose mission is to serve low- and middle-income communities), as well as targeted "impact" investments in the private markets.

Until recently, much of the growth in ESG investing has been concentrated among large institutional investors. However, interest has been growing among individual investors—particularly women and millennials, according to recent studies by **U.S. Trust** and **Morgan Stanley**. A proliferation of ESG funds has followed, as shown in Figure 2.

The increased interest in ESG investing has dovetailed with another industry growth trend: index investing. Fortunately for ESG investors with a bias toward passive investment approaches, a growing number of options (particularly ESG-oriented exchange-traded funds) are becoming available.

Of course, ESG screens, which often rely on an added layer of internal or third-party research services, can still result in higher embedded fund expenses compared to their non-screened alternatives. But it is getting easier for index-oriented investors to build well-diversified ESG portfolios at a reasonable cost.

Identifying ESG Funds

To give you a sense of the current terrain, we describe here several broad-based ESG index (passive) funds available to investors. We didn't include narrower ESG-related index vehicles focused on specific niches such as clean energy, nor did we look at funds with religious-based screens explicitly intended for faith-based investors. Moreover, we discuss only stock funds. There is still a dearth of relatively low-cost ESG fixed-income funds.

To identify the funds, we searched Morningstar's Advisor Workstation for U.S.-based exchange-traded funds (ETFs) and open-end mutual funds with the criteria below. All data are as of December 31, 2016. [Note: While Morningstar's database requires a subscription, there are currently several free online resources to search for ESG funds namely, **www.socialfunds.com** for open-end mutual funds and **www.etf.com** and **www.etfdb.com** for ETFs.]

1. First we identified funds categorized as socially conscious by Morningstar. Although Morningstar recently applied a new "sustainability" rating to close to 20,000 of the funds it covers (yet another testimony to the growing interest in ESG investing), we examined only funds that have an explicit ESG mandate as part of their investment objective.
2. Then we filtered this list to include only those funds that have:

- A gross expense ratio of 0.50% or lower. There are ESG index funds with higher gross expense ratios (meaning fund annual operating expenses as a percentage of assets, before any fee waivers), but one of the primary factors in index funds' superior performance over time relative to most actively managed funds is their lower costs. We used the gross—rather than net—expense ratio to screen out any funds that are waiving fees temporarily. This 0.50% threshold also captured low-cost, passive asset class funds that do not necessarily track commercial indexes.
- Assets of at least $100 million. We wanted to identify those funds that have a greater chance of surviving over time. This is particularly relevant for funds held in taxable portfolios, as significant unintended capital gains distributions can occur from fund closures and liquidations.

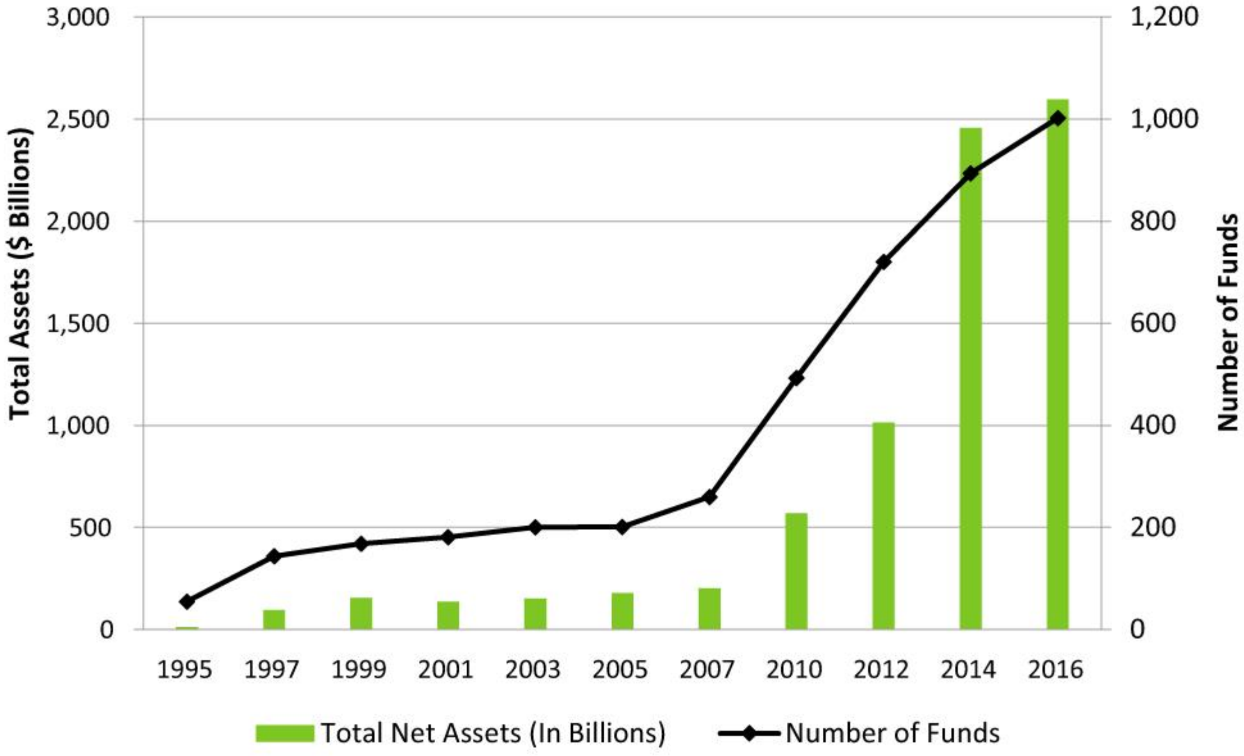

Figure 2. Growth of ESG Funds Between 1995 and 2016

In the end, however, we all know that ESG investing remains a very personal decision. So in addition to considering fundamental criteria, such as cost, portfolio turnover and tax efficiency, ESG investors need to take the time to “look under the hood” themselves and understand the rules governing the index that each fund tracks, to ensure that the fund’s social screens are aligned with their own values. Even broad-based funds have some important differences in the criteria they use to include and exclude securities. Furthermore, ESG selection criteria can result in industry sector biases, with consequent risks.

Domestic Funds

Among domestic funds, four ETFs and five open-end mutual funds met our search criteria.

The two ETFs that have the broadest ESG screens also happen to be the oldest and largest ones in this category.

iShares MSCI KLD 400 Social ETF (DSI): Launched by Barclays (BlackRock iShares’ predecessor) in 2006, BlackRock iShares MSCI KLD 400 Social tracks the first and perhaps most well-known ESG index in the United States, formerly known as the Domini 400 Social Index. As of this writing, it excludes some well-known names, including Apple (**AAPL**) and is relatively overweight in technology stocks and underweight in financial stocks compared to the broad U.S. market. The ETF carries a 0.50% annual expense ratio and has just shy of $750 million under management across 400 holdings.

iShares MSCI USA ESG Select ETF (SUSA): This second iShares ESG ETF originally tracked a subset of the Domini 400 Social Index, but in 2010 it switched to an entirely new index independent of the Domini 400. It is designed to exhibit risk and return characteristics similar to those of the unscreened MSCI USA Index. To do this, the fund caps sector deviation from this broader benchmark at 3%. Even so, both iShares MSCI USA ESG Select and MSCI KLD 400 Social currently have similar industry sector weightings. KLD is smaller than DSI (with about $470 million under management), has fewer holdings (about 120), and is slightly more concentrated in terms of its largest holdings (including, interestingly, Apple). Like MSCI KLD 400 Social, MSCI USA ESG Select carries an annual expense ratio of 0.50%.

The other two ETFs that met our search criteria are newer and have narrower ESG objectives.

SPDR S&P 500 Fossil Fuel Reserves Free ETF (SPYX): This relative newcomer was launched in November 2015 and has just over $100 million in net assets. SPDR S&P 500 Fossil Fuel Reserve Free was developed with the support of the Natural Resources Defense Council (NRDC) to meet the needs of climate-conscious investors. The S&P 500 index serves as the fund's initial universe of eligible securities; it is then screened to exclude companies with any ownership of fossil fuel reserves, including for third-party and in-house power generation. It currently has approximately 480 holdings. As one would expect, SPDR S&P 500 Fossil Fuel Reserve Free is underweighted in the energy sector relative to the S&P 500; conversely, it is overweight in technology and health care. The ETF has a gross expense ratio of 0.25%.

SPDR SSGA Gender Diversity Index ETF (SHE): Launched in March 2016, SHE tracks State Street's proprietary SSGA Gender Diversity Index, which is designed to invest in U.S. large-cap companies that are "gender diverse," meaning that they exhibit gender diversity in their senior leadership positions. The California State Teachers' Retirement System seeded this ETF with an initial $250 million investment. The fund seeks to minimize divergence from the sector weighting of the 1,000 largest listed U.S. companies. Given the current composition of executive boardrooms, however, it is significantly underweight in the technology sector and overweight in health care. Currently, there are approximately 185 holdings. It has a 0.20% gross expense ratio.

As with any ETF, investors should be mindful of costs in addition to expense ratios, including brokerage commissions and the difference between the bid and ask prices, known as the bid-ask spread. Indeed, bid-ask spreads are particularly relevant in the case of the four ETFs just described, because they trade with relatively light volume. ETFs are also bought and sold at market prices, which can differ from the funds' underlying net asset values (NAVs). However, these four ETFs consist of comparatively large liquid stocks and, not surprisingly, all traded within plus or minus 0.5% of their net asset values for the recent quarter ending December 31, 2016.

Among traditional open-end domestic mutual funds, five met our criteria. All but one of these incorporate broad-based ESG screens.

Vanguard FTSE Social Index (VFTSX): This fund tracks the FTSE4Good US Select Index, which is screened for a variety of ESG criteria and excludes companies involved with weapons, tobacco, gambling, alcohol, adult entertainment and nuclear power. The index includes primarily large- and mid-cap companies. Vanguard FTSE Social Index fund has a little more than $1.5 billion under management across about 440 holdings, and a gross expense ratio of 0.22%, the lowest among the five traditional open-end funds in this survey.

TIAA-CREF Social Choice Equity (TICRX): This is the largest of the funds and ETFs in this survey, with over $2.4 billion in total assets. Indeed, its parent company (recently renamed just TIAA, sans CREF), is a long-standing player in the ESG arena, with nearly $650 billion "committed to responsible investment principles" as of June 30, 2016, per www.tiaa.org. While not an index tracking fund per se, TIAA-CREF Social Choice Equity's objective nonetheless is "to achieve the return of the U.S. stock market as represented by its benchmark, the Russell 3000 index, while investing only in companies whose activities are consistent with the [fund's broad] ESG criteria." It also is one of the funds we identified here that most closely resembles the sector weighting of the U.S. market as a whole. TIAA-CREF Social Choice Equity Fund has about 800 holdings and a gross expense ratio of 0.44%.

Calvert U.S. Large Cap Core Responsible Index Class I (CISIX): Calvert is an established niche mutual fund company that specializes in ESG investing. Eaton Vance, a larger traditional fund company, recently announced that it is acquiring Calvert. CISIX is the only share class of this fund with an expense ratio that does not exceed 0.50%—at 0.38%—but it requires an initial investment of $100,000. Calvert U.S. Large Cap Core Responsible Index fund is composed of companies that operate in a manner consistent with Calvert's responsible investment principles and is designed to serve as an equity benchmark for U.S. large-cap core stocks. The fund has approximately 730 holdings and $900 million under management. Like others listed here, it is underweight in energy stocks and overweight in technology stocks.

DFA U.S. Sustainability Core 1 Portfolio (DFSIX): Dimensional Fund Advisors (DFA) is a large, institutional asset manager dedicated to passive investing principles. It does not track commercial indexes, but rather seeks to target several compensating risk factors (or market "dimensions") backed by academic research. Unlike the other funds surveyed, DFA does not offer its funds directly to the general public, but rather sells them through a select group of fee-only advisers (which, in the interest of full disclosure, includes our firm, ELM Advisors). DFA U.S. Sustainability Core 1 Portfolio provides total domestic market exposure, but with a more modest tilt toward small-cap and value stocks. Moreover, as the fund's name suggests, its screens emphasize environmental impact, although there are social considerations as well, such as cluster munitions manufacturing, tobacco and child labor. It has a 0.32% expense ratio, 1,940 positions and just under $860 million under management.

DFA U.S. Social Core Equity 2 Portfolio (DFUEX): This fund offers broad U.S. market exposure but with a strong tilt toward small and value-oriented stocks. Its social screens are more far-reaching than those used by DFA U.S. Sustainability Core 1 Portfolio. Notably, DFA U.S. Social Core Equity 2 Portfolio's screens exclude companies that provide abortions and/or contraceptives or that involve stem cell research, gambling, pornography or alcohol. Consistent with these screens, a prospectus filed on March 28, 2008—around the time of the fund's launch—shows that its earliest large shareholders were religious-based organizations. U.S. Social Core Equity 2 Portfolio also screens for more mainstream social concerns, including companies that engage in weapons manufacture, have business in Sudan or employ child labor. The fund has almost 2,400 holdings, a gross expense ratio of 0.29%, and about $760 million under management.

International Funds

While more international ESG index/passive options have become available over the past several years, only four funds met our criteria.

Among these, just one ETF made the grade.

iShares MSCI ACWI Low Carbon Target ETF (CRBN): Initially created for the United Nations Joint Staff Pension Fund, this fund is global, with U.S. companies representing about 50% of the portfolio. It tracks the MSCI ACWI Global Low Carbon Target Index, which seeks a lower carbon exposure than that of the broad market by overweighting companies with low carbon emissions (relative to sales) and with low potential carbon emissions (per dollar of market capitalization). The index includes large-cap and mid-cap stocks across 23 developed markets and 23 emerging markets. IShares MSCI ACWI Low Carbon Target fund traded within plus or minus 0.5% of its net asset value 86% of the days during the quarter ending December 31, 2016 (versus 100% of the days for the domestic ETFs listed above). As with all international ETFs, this may be due in part to the difference in closing times for domestic and international markets. iShares MSCI ACWI Low Carbon Target ETF has a 0.20% expense ratio and just over $310 million under management.

There were three qualifying mutual funds.

Northern Global Sustainability Index (NSRIX): This fund, managed by Northern Trust Bank, seeks to provide investment results approximating the overall performance of the securities included in the MSCI World ESG Index. This global index is made up of large-cap and mid-cap companies in developed markets. The United States represents about 60% of its holdings (the DFA funds that we describe next do not include U.S. companies). Furthermore, it is both sector- and region-neutral relative to the unscreened MSCI World Index. Unlike CRBN's underlying index, the MSCI World Index does not include emerging markets. Northern Global Sustainability Index fund has a gross expense ratio of 0.37%, almost 835 holdings and approximately $260 million in assets.

DFA International Sustainability Core 1 Portfolio (DFSPX): This fund purchases a broad and diverse group of securities of non-U.S. companies in developed markets, with a greater emphasis on small-cap and value companies compared to their representation in the international universe. DFA International Sustainability Core 1 Portfolio is the international equivalent of the aforementioned DFA U.S. Sustainability Core 1 portfolio. It carries a 0.48% expense ratio and has just over 3,100 holdings across roughly $520 million in assets.

DFA International Social Core Equity Portfolio (DSCLX): International Social Core Equity Portfolio is the international equivalent to the aforementioned DFA U.S. Social Core Equity 2 Portfolio. Its social screens are similar to those of the domestic fund, and its largest shareholders initially were also religious-based organizations per the prospectus filed on February 28, 2013. DFA International Social Core Equity Portfolio fund has almost $550 million under management, a 0.46% annual expense ratio and 3,720 holdings.

DFA also offers an Emerging Markets Social Core Portfolio, but its 0.62% expense ratio did not meet the parameters of our survey.

More ESG Funds Are Likely to Come

In conclusion, while only a small number of index/passive funds met our survey's particular criteria as of December 31, 2016, there are currently 18 traditional index mutual funds and 43 ETFs categorized as "socially conscious" by Morningstar. More are likely to come. Indeed, several new broad-based ETFs from established asset managers such as BlackRock and Goldman Sachs are currently in the process of being registered with the SEC. Nuveen (now a subsidiary of TIAA) launched five such ETFs at the end of 2016. Furthermore, each of the major indexing groups (FTSE, MSCI and S&P Dow Jones) has a growing stable of ESG indexes, presenting a wide array of licensing opportunities for potential new funds.

Although it is encouraging to see more alternatives becoming available, some noticeable gaps in asset classes remain to be filled, ideally with funds that are relatively low in cost and have garnered sufficient asset heft to ensure decent staying power. Should the current growth trajectory of ESG investing continue, chances are good that more competitively priced index/passive ESG funds will be launched over time.

This article originally appeared in the March 2017 issue of the *AAII Journal.* It was wrtten by Lorne Abramson, CFA, CFP, co-founder of ELM Advisors LLC, and Elana Lieberman, co-founder of ELM Advisors LLC.