Aligning Investments with Personal Values

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KLINGENSTEIN FIELDS
WEALTH ADVISORS

Introduction

"I hope that one day, if you ask a firm who its responsible investing officer is, every single investment professional will say 'I am' or 'we are'."
— Christopher Ailman, CIO, CalSTRS (California State Teachers' Retirement System)

For most investors, growing and protecting their wealth is top of mind. At Klingenstein Fields Wealth Advisors (KFWA), we recognize that you may also have an interest in aligning your investments with your personal values. "We understand the importance of investing with a conscience," states Michael Champness, Senior Vice President and head of the environmental, social and governance (ESG) investing working group at KFWA. "As a fiduciary, we have a responsibility to focus on traditional performance objectives. However, we also recognize the importance of considering our clients' specific values when managing their wealth." When KFWA develops values-based portfolios, we use a customized approach that integrates our investment ideas with the personal values of our clients.

The desire and path to investing responsibly has evolved over time. The first iteration revolved around Socially Responsible Investing (SRI), which focused on including or excluding a company based primarily on its lines of business. Unfortunately, there is considerable debate regarding the return potential of pure SRI strategies.

From the mixed results of the first iteration of SRI, responsible investing further evolved. Client awareness and demand grew, and more sophisticated analytical tools were introduced. As a result, professional investors began to consider a wider array of criteria across three main categories, environmental, social and governance, leading to what has become broadly known as "ESG investing." At the heart of ESG is the belief that companies rated highly for ESG factors are more likely to succeed in the long term, putting them more in sync with investors' goals of strong investment performance. This ESG process continues to evolve today and now can accommodate a wide array of personal beliefs and investment goals.

Socially Responsible Investing (SRI): As Old as the Bible

SRI is not a new concept[1]. In fact, the origins can be traced back to biblical times when Jewish and Islamic laws, directives and teachings established guidelines for investing ethically and morally. Many experts consider the contemporary roots of SRI to be an outcome of the sweeping political change in the 1960s, when social issues, including the Vietnam War, the civil rights movement, environmental concerns and women's equality came to the forefront.

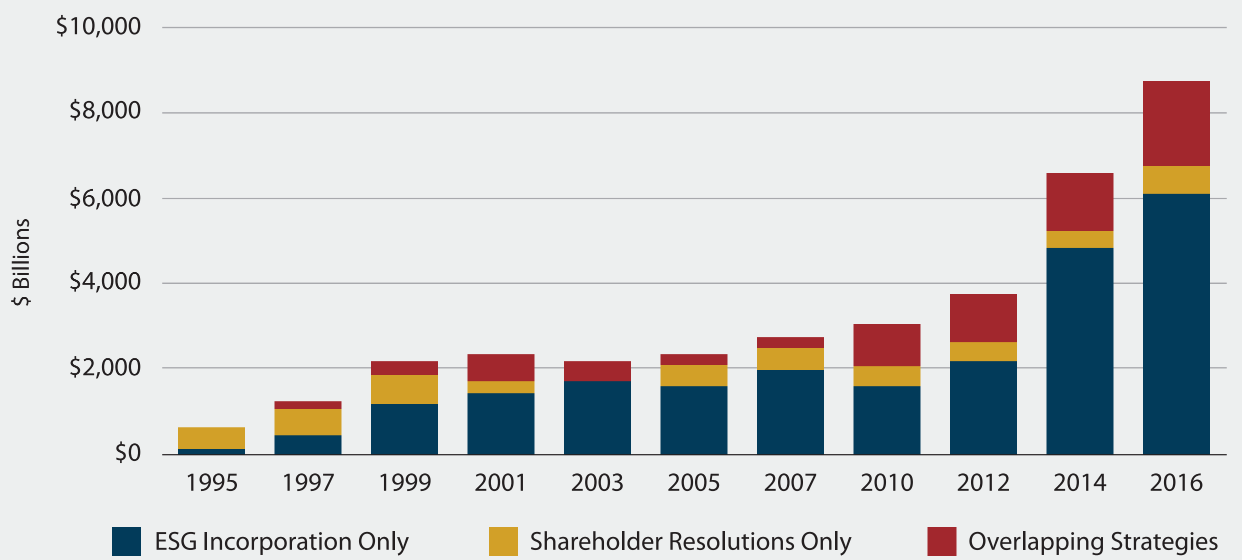
The Early Stage of Modern Day SRI

Traditional SRI involves making decisions to include or exclude individual companies based on social, moral, ethical or religious screens. The classic example of SRI investing is the exclusion of "sin" stocks, such as companies that are involved in some way in alcohol, gambling, firearms, tobacco or other areas deemed as socially harmful. Slow growth occurred in SRI through the 1980s and 1990s.

Substantial Growth

While SRI may have been somewhat slow to take off, in recent years, it has grown to represent a sizable portion of professionally managed assets in the U.S., driven by environmental disasters, concern about climate change, mass shootings, the push for gender identity awareness and other issues. According to the 2016 Report on U.S. Sustainable, Responsible and Impact Investing Trends, SRI/ESG assets grew 33% from 2014 to the beginning of 2016 to reach a total of $8.72 trillion in assets. These assets now comprise approximately one-fifth of all professionally managed assets in the U.S.

Sustainable, Responsible and Impact Investing in the United States 1995-2016



Source: US SIF Foundation

[1] The SRI Conference on Sustainable, Responsible and Impact Investing

But are "bad" Companies "bad" Investments?

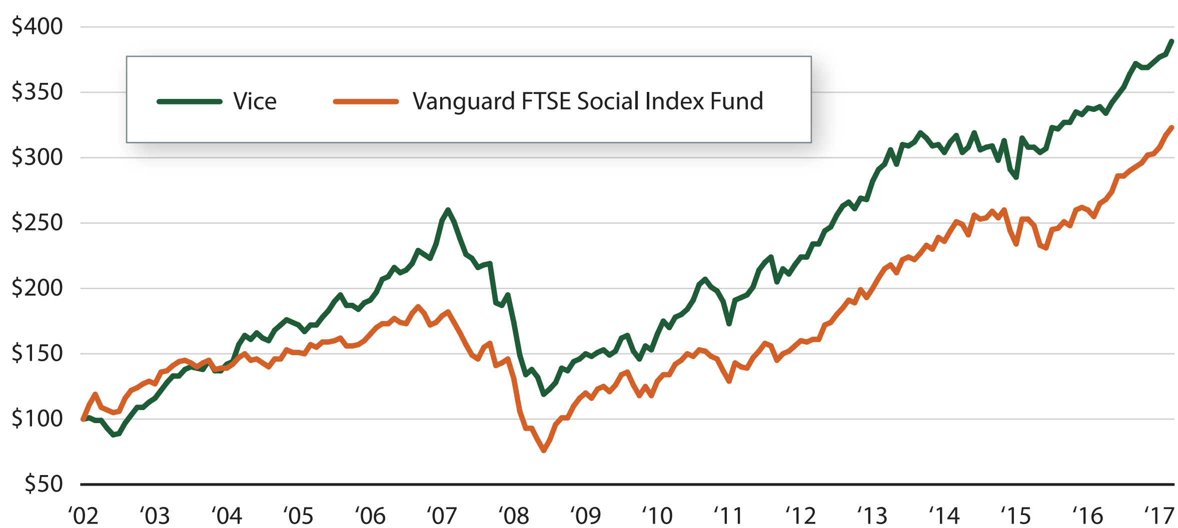
SRI seems like a reasonably clear way to invest with a social conscience. But when you dig beneath the surface, it's not quite as transparent. One may say that "sin" stock companies that derive revenue from gambling, alcohol, tobacco or guns are engaging in businesses that are "bad" for society. Unfortunately, some of these businesses, at least in the short- to medium term, may possess the potential for solid investment returns when assessed on their fundamental characteristics. Many of these companies, such as those in the tobacco industry, are unlikely to encounter new competitors, plus they tend to be in businesses which are somewhat recession proof (gambling being an exception). "Interestingly, despite the decline in smoking in the developed world, many tobacco stocks have been strong and steady outperformers over time," notes Champness. In addition, by avoiding specific industries, you may be reducing diversification and taking on risk in your portfolio.

The Proof is in the Data

Research appears to bear this out with a variety of studies finding that sin stocks perform strongly. Most recently, in a 2015 study published by Credit Suisse, researchers from the London Business School looked at two funds, the Vice Fund (since renamed the Barrier Fund) and the Vanguard FTSE Social Index Fund, two U.S. mutual funds launched in the early 2000s. The Vice Fund invests in what would be considered socially/morally/ethically negative, while the Social Index Fund consists of companies that have been screened for SRI/ESG criteria. Examined over a period from the end of August 2002 (when the Vice Fund launched) through the end of 2014, allowing the funds to experience full market cycles, it's clear that Vice outperformed Social values by a significant amount. But, as we will see, for investors who want to invest with their conscience, newer ways to execute values-based investing have had far better results.

The Vice Fund and Vanguard FTSE Social Index Fund 2002-2017

Cumulative value of $100 invested



Source: Yahoo Finance, data for The Vice Fund and the Vanguard FTSE Social Index Fund from 2002-2017, assumes all dividends are wholly reinvested.

New ways to execute values-based investing have had far better results.

Different types of socially responsible and sustainable investing defined:

	Description	Pros	Cons
Socially Responsible Investing (SRI)	Primarily based on screens that determine whether to include or exclude companies based on social, moral, ethical or, in some cases, religious criteria.	• Provides comfort of knowing your values are aligned with your investing • Strict definition provides clear guidance on what is acceptable/ unacceptable for investment purposes	• Ignores the investment potential of a company • May be "sinful" in some ways, but trying to "do good" in other areas • Exclusion may limit ability to achieve a diversified portfolio
Environmental, Social and Governance (ESG)	Looks at how a company operates across an array of environmental, social and governance criteria to determine a company's ability to positively impact society and achieve favorable investment results. May include engagement.	• Incorporates investment potential into the evaluation • Can be seen as a complement to fundamental analysis	• May result in overly activist investors
Impact Investing	Impact investments are investments made into companies, organizations, and funds with the intention to generate social and environmental impact alongside a financial return.	• Clear emphasis on and balance between and measurement of both ESG impact and financial return	• Adhering to values may conflict with generating returns

The Next Evolution

As investors became aware that exclusion or inclusion based almost purely on social, moral, ethical or other socially conscious criteria did not necessarily translate into sound financial returns, they sought ways to consider both investment and social criteria in making their decisions. This led to the rise of investing based on ESG factors.

ESG Defined

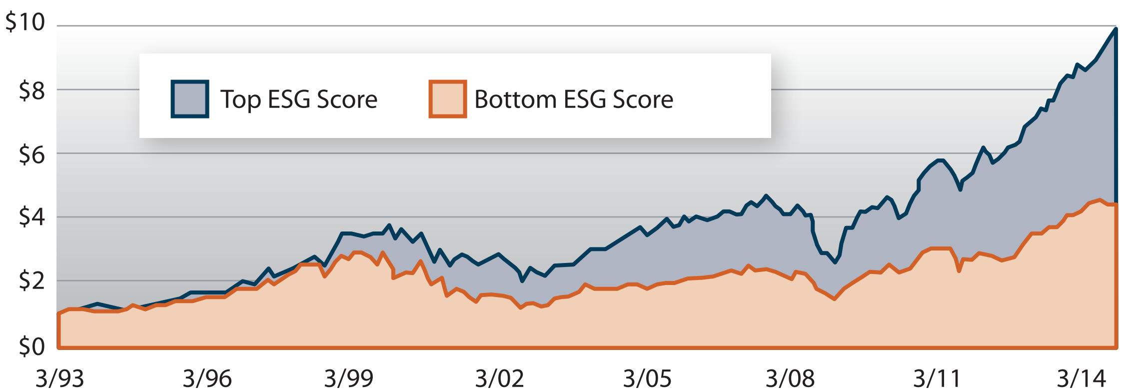
Simply put, ESG looks at a company in terms of how it "performs" in the areas of environmental, social and governance practices. Criteria may include issues such as climate change in environmental, gender and diversity in social and executive compensation in governance. Some of the most commonly examined factors are shown in the table below.

ENVIRONMENTAL ISSUES	SOCIAL ISSUES	GOVERNANCE ISSUES
• Climate change and carbon emissions • Air and water pollution • Biodiversity • Deforestation • Energy efficiency • Waste management • Water scarcity	• Customer satisfaction • Data protection and privacy • Gender and diversity • Employee engagement • Community relations • Human rights • Labor standards	• Board compensation • Audit committee structure • Bribery and corruption • Lobbying • Political contributions • Whistleblower schemes

Source: CFA Institute

Companies that rate highly for these factors may be better positioned to change, innovate and evolve, making them stronger potential long-term investments. ESG investing can be viewed as an additional or deeper layer of quantitative and qualitative analysis that rounds out the pure financial picture with other information that may provide insight into and influence over company behavior and performance. "Disciplined, methodical fundamental analysis still continues to be at the core of our investment process," Champness reiterates. A recent research study, by Mozaffar Khan, George Serafeim and Aaron Yoon, found companies that engage in sustainable behavior, i.e., rated higher in ESG, outperformed companies that rated poorly for ESG over a 20-year period from 1993 to 2014.

Evolution of $1 Invested in March 1993



Source: Mozaffar Khan, George Serafeim, and Aaron Yoon, "Corporate Sustainability: First Evidence on Materiality," The Accounting Review, forthcoming, http://ssrn.com/abstract=2575912

ESG (Environmental, Social and Governance) Investing is defined as a focus on identifying companies that create a positive impact through their business operations and overall activities.

Alpha is defined Alpha, often considered the active return on an investment, gauges the performance of an investment against a market index used as a benchmark, since they are often considered to represent the market's movement as a whole. The excess returns of a fund relative to the return of a benchmark index is the fund's alpha.

Combining the ideas of impact investing and ESG goes further by focusing on those companies that not only rate highly for ESG factors but also possess strong potential to influence change in defined areas.

Our Approach

At KFWA, we are committed to offering you investment solutions that align with your personal and wealth planning goals. We believe that is best accomplished through a highly personalized approach based on your individual interests and concerns. We engage in an interactive dialogue that helps us to understand your values and address any questions you may have about performance, asset allocation and diversification when investing through an ESG lens. Our goal is to achieve this in an efficient and systematic way that:

- Uses our proven investment process and leverages the best thinking of the firm
- Seeks to maintain diversification and meet your investment goals

We work to deliver ESG and impact investing solutions that are high quality and competitive. Our research group explores corporate transparency on a wide range of issues and assesses ESG information and criteria, evaluating and refining our ESG approach based on market conditions and analyzing performance of our ESG models. In addition, we participate in industry conferences, forums and other events to further our knowledge and understanding as ESG investing continues to evolve. Your team at KFWA can engage with you on ESG topics and make recommendations based on your ESG views and wealth objectives. We welcome the opportunity to meet with you and your family to discuss incorporating your values and mission into your wealth plan and investments. For more information, please contact us at 212.492.7000 or email us at info@klingenstein.com. We look forward to hearing from you.

IMPORTANT DISCLOSURES

Past performance may not be indicative of future results. Different types of investments involve varying degrees of risk. Therefore, it should not be assumed that future performance of any specific investment or investment strategy (including the investments and/or investment strategies recommended and/or undertaken by Klingenstein Fields Wealth Advisors ("KFWA")), or any non-investment related services, will be profitable, equal any historical performance level(s), be suitable for your portfolio or individual situation, or prove successful. KFWA is neither a law firm nor accounting firm, and no portion of its services should be construed as legal or accounting advice. If you are a KFWA client, please remember that it remains your responsibility to advise KFWA, in writing, if there are any changes in your personal/financial situation or investment objectives for the purpose of reviewing/evaluating/revising our previous recommendations and/or services, or if you would like to impose, add, or to modify any reasonable restrictions to our investment advisory services. A copy of our current written disclosure statement discussing our advisory services and fees is available upon request or by clicking here. Please read the expanded disclosure in the linked report or by visiting our website at www.klingenstein.com.

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