Economic Analysis

Values-Based Investing Gains Mass Appeal

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- **Values-based investing (VBI) accounts for $6.6 trillion of assets under management**
- **VBI is shifting from negative to active / positive screening**
- **Increasing demand is making VBI a prominent investment method**

"You cannot get through a single day without having an impact on the world around you. What you do makes a difference, and you have to decide what kind of difference you want to make."

—Dame Jane M. Goodall

Values-based investing (VBI) is becoming a standard method rather than a niche alternative demanded by socially-conscious investors. VBI provides an opportunity for investors to balance risk and return with ethical values. Although VBI is not new, the increasing awareness of social issues boosted by hyper-connectivity, the increasing adoption of corporate social responsibility principles and the availability of specialized funds have increased the attractiveness of this form of investing. The most common VBI vehicles are mutual funds and more recently ETFs. However, other alternatives include venture capital, crowdfunding and private equity.

What motivates VBI?

On a global level, the causes championed by various investment funds are varied and encapsulate institutional investors' growing responsible investing mandates. One example, the green bond, has surged in popularity recently, especially as developing countries such as India and China move towards more eco-friendly policies. These bonds raise capital for environmentally-friendly and sustainable projects. Today, climate change is the most considered environmental factor for money managers and institutional investors engaged in VBI, with assets worth $275.6 billion and $551.5 billion, respectively in 2014.[1] Other causes popular among VBI investors include social enterprises dedicated to promoting gender equality and improving access to infrastructure and basic services in poor areas.

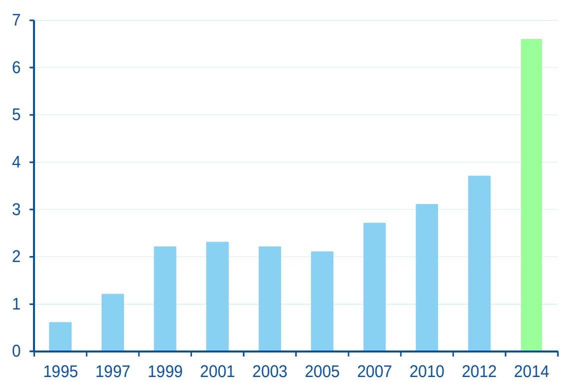
Several large asset managers and institutional investors have confirmed their commitment to VBI by agreeing with the Principles for Responsible Investment (PRI) launched by the United Nations (UN) in 2006. The PRI urges investors to analyze environmental and social factors along with risk and return when considering an investment. The UN cites increasing evidence that these factors can be material to portfolio performance in the long-term by resulting in lower risk and higher returns as well as improving society's wellbeing. The 1,380 PRI signatories, including asset owners, investment managers and service providers, currently have $59 trillion in assets under management, up from $4 trillion in 2006.[2]

In the U.S., the roots of VBI can be traced back to the 18th century, when certain religious groups in the American colonies refused to patronize or invest in the slave trade or in companies associated with guns, liquor

[1] US SIF Foundation, http://goo.gl/C9guCG
[2] UN, http://goo.gl/0ntD3B

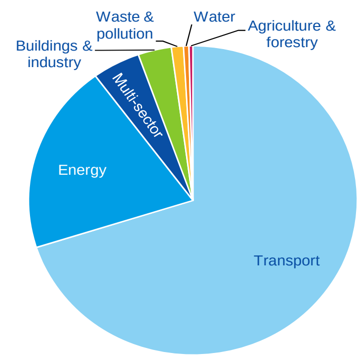
or tobacco. Modern VBI emerged during the politically-wrought 1960s and 70s, with investors refusing to put their money in companies that did not enforce civil rights or that profited from the Vietnam War. Currently, environmental, social and governance issues are dominant among the types of VBI available. New trends in VBI are emerging, for example, concerns over military and weapons productions have been applied to over $588 billion in assets owned by money managers, a 400% increase over the last two years.[3] This substantial increase was spurred by the rising number of mass shootings in the U.S. More recently, place-based investing has emerged as a trend, encouraging investors to commit capital to local businesses, community projects or municipal bonds. As a result, new apps such as Neighborly and BlocPower have gained popularity, allowing anyone to search for public projects in their community and invest directly or through municipal bonds.

Chart 1
U.S. | Total Funds in VBI
Trillions, $



Source: US SIF Foundation

Chart 2
Global | Outstanding Green Bonds by Category*
Billions, $



Source: Climate Bonds Initiative. *Issued after Jan. 2005

What approaches are used?

We identify two primary values-based investing techniques for the purposes of this report:

Negative screening: Without actively seeking environmental and social impact, this technique involves eliminating or avoiding portfolio investments that conflict with the investor's ethical values. A common example is excluding companies associated with industries that may present a conflict with certain religious, moral or ethical values such as alcohol, tobacco or firearms. Traditionally, negative screening has been widely used among investment managers responding directly to clients' wishes to remove certain industries from their portfolios. These clients are primarily institutional investors who want to make sure that their portfolios do not include assets that conflict with their mission statement or shareholder resolutions.

Impact investing: Also known as 'active screening,' this category involves using a positive screening technique to invest with a bias and funnel capital directly towards companies or sectors that align with one's goals. An example is the emerging popularity of green bonds in the fixed-interest markets, designed to support sustainable building and development. Another example are successful Silicon Valley entrepreneurs who want to give back to the start-up community by setting aside part of their fortunes to become angel investors. As more individual

[3] US SIF Foundation, http://goo.gl/Lf7neL

investors take interest in VBI, the tide is moving towards active or impact investing techniques, as many of these investors view negative screening as too narrow to fully encompass their values.[4]

Who are the investors?

Participants in VBI include individuals, institutions, investment firms, money managers and banks that typically seek both positive long-term returns and positive societal impact. In a survey conducted by the U.S. Forum for Sustainable and Responsible Investment, 80% of investment managers cited client demand as the motivation behind integrating social and environmental issues into their investment analyses.[5]

The majority of VBI clients are foundations or institutional investors who seek to align their investments with their mission and values. However, demand among individual investors has also increased in recent years. In particular, younger clients are becoming more aware of the potential returns and impact of VBI and are increasing their demand for it. Surveys show that 45% of high net worth Millennials expressed interest in using their wealth to help others and consider social responsibility when investing, compared to just 30% of Gen X and Baby Boomers.[6] Additionally, 29% of Millennials reported that they expect their financial advisors to provide VBI.[7] These figures are consistent with other surveys that point to the stronger civic involvement of young adults now compared to previous generations. According to an Associated Press-GfK poll, the share of adults under 30 years old that agreed that citizens have a “very important obligation” to volunteer increased by nearly 53% from 1984 to 2014.[8]

Moreover, the proliferation of the internet, mobile devices and social media has increased opportunities for younger generations to gain awareness and engage with environmental and social causes in a more streamlined way than previous generations. A survey from the American Press Institute found that 88% of Millennials got news from Facebook, 83% from YouTube and 50% from Instagram.[9]

The popularity of VBI among young investors may also have to do with their increased educational attainment. Millennials are the most educated generation in America with a larger share of individuals holding higher degrees. In 2014, the proportion of individuals 25-29 years old with four years of college or more reached 34%, the highest on record. By comparison, the share of 25-29 years old individuals with four years of college or more was 7.7% in 1950; and 22.5% in 1980.[10] These higher education levels could be impacting Millennials’ career aspirations as well; 85% prefer to do work that allows them to improve themselves and the world around them, while 71% seek careers at companies that encourage community involvement and social responsibility.[11] By aligning their roles as educated professionals with their personal values, today’s young adults seek to build portfolios which reflect their view of how the world should be. With their higher education, desire to effect positive change and the abundant resources available to expand their worldview, Millennials and future generations are the ideal candidates to drive growth and awareness of VBI. By the time today’s young adults reach their peak earning years, they could make VBI the norm, rather than the exception.

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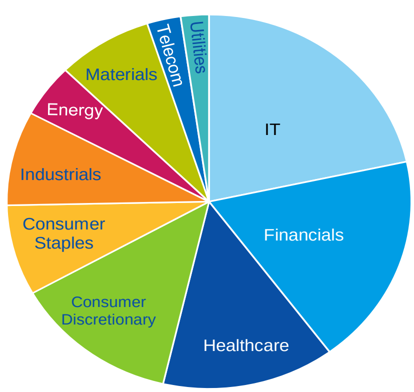
[4] Commonfund, https://goo.gl/mf3d0y
[5] US SIF Foundation, http://goo.gl/AqXkct
[6] ImpactAssets, http://goo.gl/eA9RVL
[7] Bank of America, Merrill Lynch, http://goo.gl/aoPSVp
[8] Philanthropy News Digest, http://goo.gl/OJCLWl
[9] American Press Institute, http://goo.gl/LKZIZp
[10] National Center for Education Statistics, Department of Education, https://goo.gl/ld5LHE
[11] ImpactAssets, http://goo.gl/IEfkho

Is it profitable?

Investors interested in VBI have two purposes in mind: to maximize returns and to have a positive impact, but these two factors are not always balanced. Nevertheless, firms incorporating social and environmental issues into their business models have been shown to have comparable stock market performance and profitability to non-VBI options. In one measure of positive returns, annualized one and three-year returns for the S&P 500 Environmental & Socially Responsible Total Return Index (SPXESRP) are higher than those of the S&P 500 by 32.5% and 3.2%, respectively. In 2014, total returns for the SPXESRP were 15.9%, while the S&P 500 was at 13.7%.[12] In another measure, a 2013 HBS study concluded that $1 invested in a portfolio composed of companies that voluntarily adopted social and environmental factors between 1992 and 2010 would have outperformed a control group by 47%.[13]

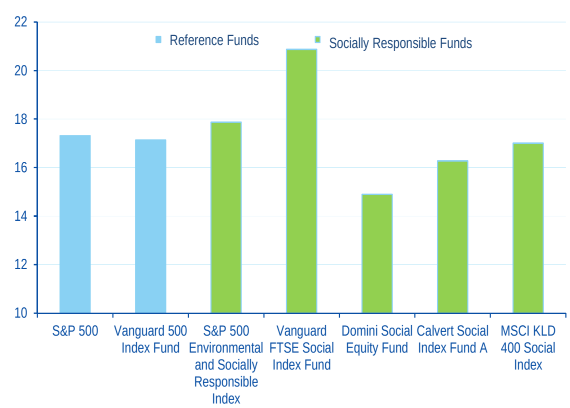
The sheer growth of VBI in recent years suggests that more investors consider returns from this alternative to be greater than or at least on par with those of traditional investments. In the last 20 years, VBI assets have increased tenfold in the U.S., from $639 billion in 1995 to $6.6 trillion in 2014–one out of every six dollars under management and 37% of nominal GDP.[14] In particular, foundations, university endowments and state pension funds have increased their investments in values-based funds. This offers further evidence of the competitiveness of VBI as these organizations are legally obligated to seek competitive returns for their portfolios. However, as with any investment, VBI is exposed to market shocks, especially when using impact investing techniques which might result in a less diversified portfolio. For example, a fund that centers on clean energy companies would have been likely to decline upon the drop in oil prices earlier this year, as clean energy was a less appealing alternative at that point.

Chart 3
Average Sector Weights for Selected VBI Funds
%



Sources: S&P Dow Jones, Vanguard Group, Domini Social Investments, Calvert Investments, MSCI

Chart 4
3-yr Annualized Returns for Selected Index Funds
%



Sources: S&P Dow Jones, Vanguard Group, Domini Social Investments, Calvert Investments, MSCI

12 S&P Dow Jones, http://goo.gl/qAQj2C
13 Harvard Business School, http://goo.gl/zcMHSE
14 US SIF Foundation, http://goo.gl/rn57Bb

Bottom Line

The significant growth in VBI reflects growing awareness of social and environmental issues, presence of these factors in multiple asset classes and their integration in investment analysis. Today, several big names in banking, along with investment entities and non-profits, have actively engaged in offering VBI options to their clients. By doing this, they avoid alienating investors who increasingly demand assets that comply with their views of the world while providing attractive returns. Although roughly half of asset managers still practice negative screening, a growing number of clients views this approach as too restrictive and are thus shifting to positive screening. Thus, asset managers must keep in mind the increasing presence and visibility of impact investing when developing and marketing new products. In turn, the growth of VBI could also incentivize companies to incorporate social and environmental responsibility into their business practices in order to attract investors. This could create a positive feedback loop with great benefits for society as a whole.