ESG - Done the right way

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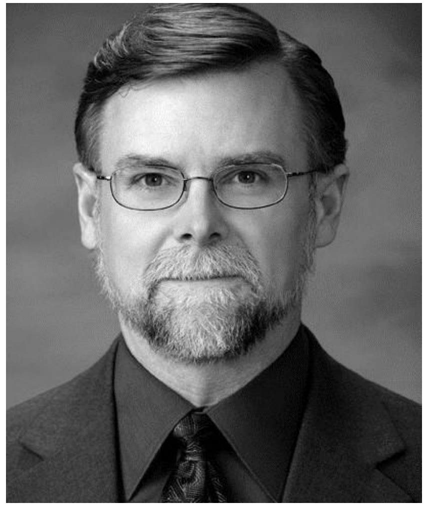

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ESG - definition

- Started in Europe
- Very well developed over there

- Here in U.S.
  - Far behind Europe
  - Very old
  - First called “socially responsible investing”
  - Also touched on “economically targeted investments”
    - Restricted to public pension plans

Can you have both - superior investment results and ESG/SRI

- Common claim
- You can have it all
    - ESG . . . Socially responsible investing
    - Superior risk-adjusted returns

    - Doing good
    - Superior investment returns

- Let's examine this contention

Is it a rewarded Beta?

If true . . . then it makes sense . . . as a passive or index ETF

Consider fixed income

- Checking account
- Money market
- Bank CD
- Ultra short term bond fund
- Short term bond fund
- Intermediate term bond fund
- Long term bond fund
- High yield (junk) bond fund
- Emerging country bonds in local currencies
- Destressed and bankrupt debt

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Low return, low risk

High return, high risk

Consider the full range of asset categories

- Money market fund
- Treasuries
- Investment grade bonds
- High yield bonds
- Emerging country debt in local currencies
- Physical real estate, bricks & mortar
- Developed country stocks
- Emerging market stocks
- Distressed private debt
- Venture capital

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Lesson - the takeaway

- You're rewarded for taking risk
- You're penalized for seeking safety

- The marketplace is incredibly efficient

- It rewards you for taking *"non-diversifiable"* risk . . . . risk that can't be diversified away

- This is why you get the tradeoffs just described . . . 2 prior slides
- This is called "Beta"

Apply this lesson/takeaway to ESG or SRI

- If companies that strongly comply with ESG criteria . . . and
  - As a result, they're inherently and fundamentally more likely to fail or otherwise get into trouble
  - This additional risk . . . can't be diversified away
- Then . . . the market will reward such companies with a HIGHER rate of return
- In such a case . . . ESG becomes a rewarded factor risk . . . a Beta

What do you think

- QUESTION - Are companies that comply with ESG criteria inherently and fundamentally more likely to fail . . . or otherwise get into trouble?

- If YES . . . . they will deliver a higher return

- If instead they have a lower likelihood of failure or trouble . . . . then they must deliver a lower return

Is ESG a Beta . . . . is it a non-diversifiable source of risk

- ESG . . . . it's really easy and incredibly transparent

- It's simple and remarkably straightforward
  - Is following ESG a source of danger and risk
  - Is that additional risk non-diversifiable
  - If so . . . . then the markets must reward (with higher returns) those companies that pursue ESG

- My perspective on this question
  - Such a suggestion . . . this is the biggest crock
  - It's remarkably embarrassing to suggest such a thing

So how do we explain the industry's response to ESG

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- One possible explanation
- ESG is not a Beta
- It earns absolutely no inherent reward or penalty . . . the market couldn't care less . . . inherently or fundamentally

- BUT . . . it's a temporary source of alpha . . . and you really really need to appreciate that word "temporary"

Is ESG a possible useful tool for seeking Alpha

Recall . . . . Alpha is only available when the market has mispriced a security

What's Alpha ?

- Alpha . . . . let's ground ourselves with a definition

- The market has screwed up
- The market has mispriced one security relative to another security

- Alpha is the extra performance resulting from
  - Correctly identifying this relative mispricing between securities
  - And . . . successfully harvesting it . . . net of all expenses

- The simple act of harvesting Alpha (a relative mispricing) . . . serves to eliminate the opportunity . . . . closing the relative mispricing . . . eliminating the opportunity

What does Alpha have to do with ESG

- Some have suggested that
  - ESG meaningfully affects the ability of a company to succeed or fail . . . it makes a big difference
  - The market is not adequately taking this ESG affect into account
  - Different securities are therefore temporarily mispriced . . . one relative to another, because security analysts and portfolio managers have not yet adequately taken ESG into account

- If all three of these are true, then
  - Use of ESG analysis may be a temporary method for seeking superior risk-adjusted returns
  - One would only approach ESG using active portfolios . . . and never passive or index

Rob's view on ESG as an Alpha source

- I can't say "no"
- Yes . . . . I'm a little skeptical . . . . but I can't say "no"
- If true . . . . then one had better be intensely//incredibly active
- Never never passive or index . . . . . which would prevent the slightest hope of success
- My suspicion . . . and where I come from . . . if you want more of one, then you'll have less of the other

Our industry's approach to ESG

The good, the bad, and the ugly

Wall Street Journal article on the truth about ESG

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OPINION | INSIDE VIEW

The Many Reasons ESG Is a Loser

By Andy Kessler Follow
July 10, 2022 11:57 am ET

You'll pay far higher expenses for a fund with similar stocks but worse performance.

A few years ago, a guy with a famous last name who ran a socially responsible investment fund asked me to lunch. I was hesitant because I figured he was planning to yell at me for a column I had recently written: "Stocks Weren't Made for Social Climbing." I wrote, "Profits are the best measure of a business's value to consumers—and to society." Instead, he was quite pleasant, though while I ate, he complained that most other environmental, social and governance funds weren't all that socially responsible compared with his—"not ESG enough." I asked him what was in his portfolio, expecting Tesla or some oat-milk company. He answered, " General Motors . " OK then.

These days ESG is big business, with $2.77 trillion in "global sustainable fund assets." The average expense ratio is 0.41%. And sure enough, apparently some funds aren't ESG enough. Police in May raided the European offices of Deutsche Bank 's DWS unit in an investigation of "greenwashing"—saying its investments were more sustainable than they were. The authorities claim, "We've found evidence that could support allegations of prospectus fraud." In June the Securities and Exchange Commission announced an investigation into Goldman Sachs for claiming some of its funds were sustainable and ESG when they really weren't. This is a fight over branding. What has the investment world

Wall Street Journal 2nd article on the truth about ESG

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OPINION | LETTERS

The Story Behind the Rise of ESG Investing

July 14, 2022 11:14 am ET

The industry needed a way to profitably reprise the old fund-management business.

I agree with Andy Kessler that environmental, social and governance investing (ESG) is frequently a branding exercise designed to fatten the profits of investment managers and otherwise underperforming companies ("The Many Reasons ESG is a Loser," Inside View, July 11). But I don't think ESG is merely an example of successful marketing. It has grown so quickly in part because it also helps fill a hole left by the recent evolution of the financial markets over the past 30 years. The key elements of that evolution are:

Practical ESG issues

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- Greenwashing
- Quality and relevance of the data . . . stocks versus bonds versus other
- ESG . . . . only exists within the context of a specific set of very personal values (person specific)
- Story versus substance
- The ultimate craven despicable story-telling
- Classically . . . crap product

- BUT . . . there are genuine well-aimed efforts

I'm so seriously pissed off

- Hypothetical story
- Large and growing roster of clients are demanding ESG . . . reinforced by political dynamics and societal trends
- Sales and reputational opportunity is identified . . . by the investment manager
- Build a new set of ETFs
  - Claiming ESG
  - Promote the proposition that ESG is an inherently rewarded non-diversifiable risk (a Beta)
  - Increase the expense ratio of these new ETFs by 500% to 600% to 700%
  - Stick these new ultra-high-fee ETFs inside their model portfolios that they sell/deliver to advisors and financial planners
  - And . . these new "ESG" ETFs aren't really any different from their non-ESG ETFs
- If such an organization exists . . . there's only one word to describe them . . . "Dirty"

Julex offers a marvelous ESG offering

I use it with some of my clients

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This is a concentrated portfolio

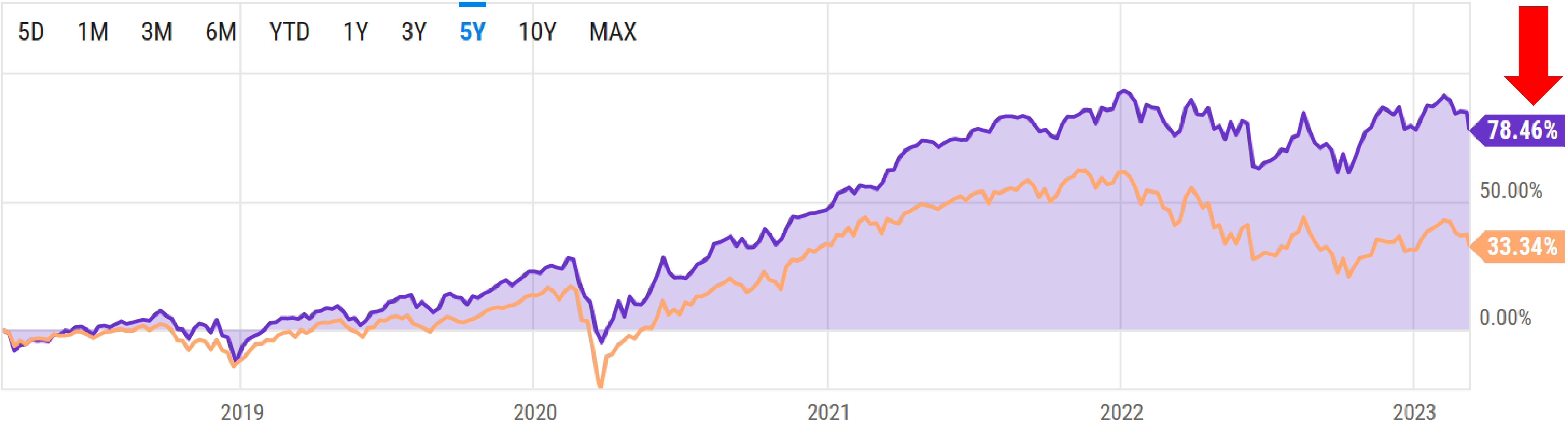
The version I use is

- **25 stocks**
- **Equal-weighted**

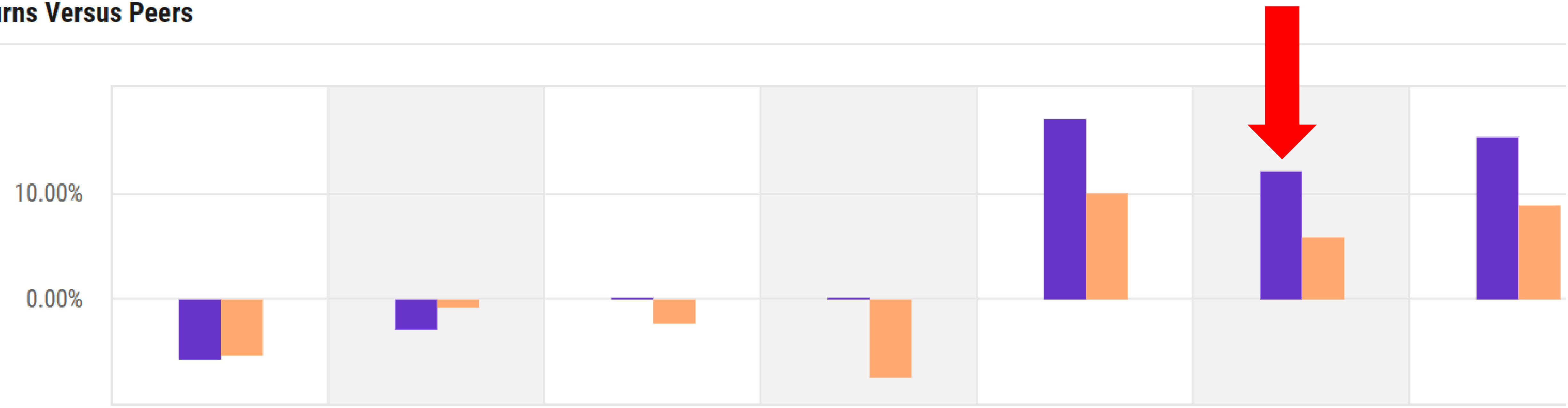
Level Chart

Show Benchmark Comparison LEVEL **RETURNS** **VIEW FULL**

- CONCENTRATED ESG YEARS 21 AND GREATER (P:548605) LEVEL % CHANGE
- 99/1 U.S. BIASED (70.9% ALL-CAP U.S. STKS, 14.1% DEVELOPED COUNTRY INT'L, 14.1% EM STKS, 0.9% T-BILLS) (P:564562) LEVEL % CHANGE



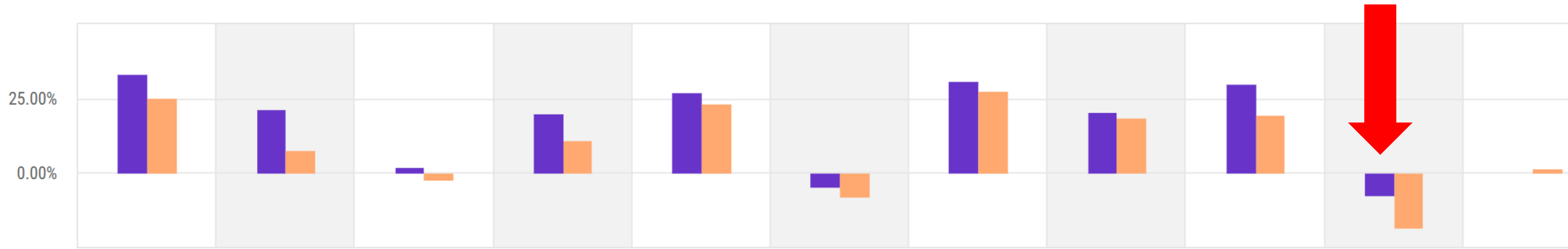
Periodic Total Returns Versus Peers



Name	1M	3M	6M	1Y	3Y	5Y	10Y
Concentrated ESG Years 21 and Greater	-5.63%	-2.81%	0.21%	0.20%	17.15%	12.28%	15.52%
99/1 U.S. Biased (70.9% All-Cap U.S. stks, 14.1% Developed Country Int'l, 14.1% EM stks, 0.9% T-Bills)	-5.22%	-0.67%	-2.29%	-7.33%	10.06%	5.92%	8.91%

As of March 10, 2023. Returns for periods of 1 year and above are annualized.

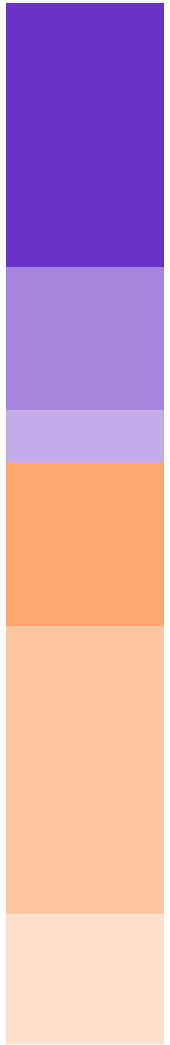
Annual Total Returns Versus Peers



Name	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	YTD
Concentrated ESG Years 21 and Greater	33.51%	21.75%	1.93%	20.12%	27.12%	-4.42%	31.16%	20.72%	30.09%	-7.53%	0.04%
99/1 U.S. Biased (70.9% All-Cap U.S. stks, 14.1% Developed Country Int'l, 14.1% EM stks, 0.9% T-Bills)	25.47%	7.91%	-2.08%	11.27%	23.18%	-7.80%	27.86%	18.53%	19.78%	-18.29%	1.39%

As of March 10, 2023.

Stock Style Exposure (?)

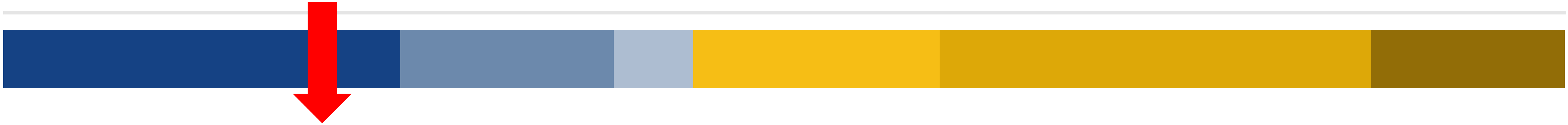


Large Cap Value	25.43%
Large Cap Blend	13.70%
Large Cap Growth	5.09%
Mid Cap Value	15.76%
Mid Cap Blend	27.59%
Mid Cap Growth	12.43%
Small Cap Value	0.00%
Small Cap Blend	0.00%
Small Cap Growth	0.00%

As of March 12, 2023

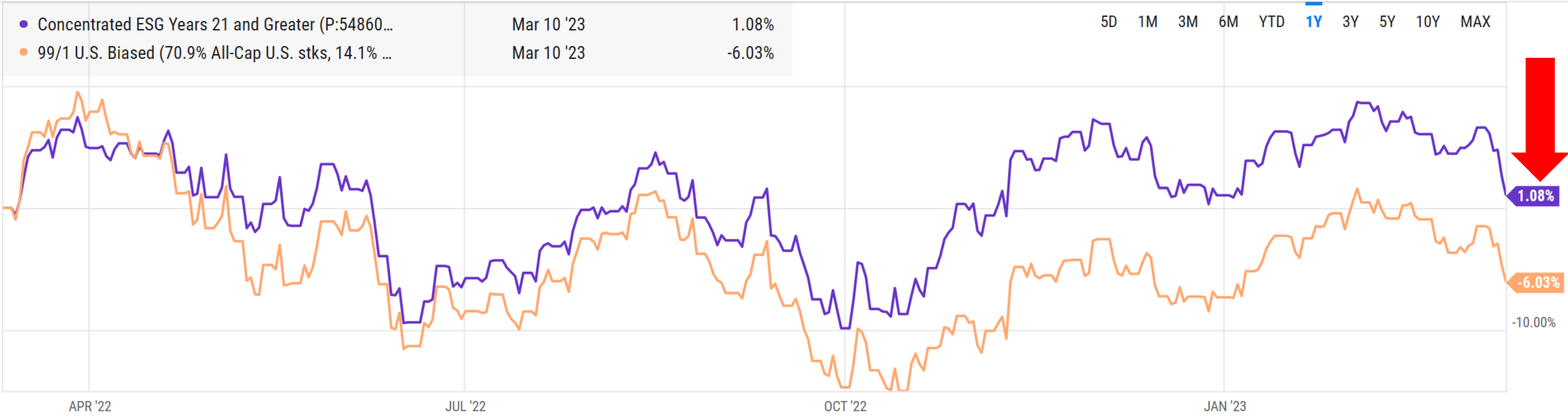
Stock Style Exposure

Data as of: March 12, 2023



	Concentrated ESG Ye..Greater	Bmark		Concentrated ESG Ye..Greater	Bmark		Concentrated ESG Ye..Greater	Bmark
Lg Cap Value	25.43%	16.16%	Mid Cap Value	15.76%	5.50%	Sm Cap Value	0.00%	2.49%
Lg Cap Blend	13.70%	28.52%	Mid Cap Blend	27.59%	8.97%	Sm Cap Blend	0.00%	3.10%
Lg Cap Growth	5.09%	28.80%	Mid Cap Growth	12.43%	4.77%	Sm Cap Growth	0.00%	1.68%

Cumulative Total Returns Versus Peers



Risk Info

Data as of Feb. 28, 2023

		3 Yr.	5 Yr.	10 Yr.
Alpha	Concentrated ESG Years 2...Greater	9.868	6.896	7.161
	Benchmark	-1.992	-2.335	-2.331
Beta	Concentrated ESG Years 2...Greater	0.8941	0.9746	0.9545
	Benchmark	0.9519	0.9474	0.9584
Standard Deviation	Concentrated ESG Years 2...Greater	17.00%	18.51%	15.20%
	Benchmark	17.63%	19.07%	15.44%
Historical Sharpe	Concentrated ESG Years 2...Greater	1.164	0.7809	1.098
	Benchmark	0.6204	0.3917	0.6333

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Disclosure

Portfolio Rebalance: Each portfolio listed on this report contains a rebalance frequency. This can be selected when you create the portfolio on YCharts. The Portfolios are rebalanced to the proper target weights at each target rebalance point. For monthly rebalancing, the portfolio will rebalance to the target weight at the end of each calendar month. For quarterly rebalancing, the portfolio will rebalance to the target weight at the end of each calendar quarter (March 31st,June 30th, September 30th, December 31st). For annual rebalancing, the portfolio will rebalance to the target weight at the end of each calendar year.Lastly, if the portfolio never rebalances, the target weights are implemented at the portfolio inception date, but will not change after that.

Portfolio Weights : All stated portfolio weights are based on allocation choices input by the creator of this report. These weights represent the values used at rebalance periods and not necessarily the implied weights at the time this report was generated. All weightings ignore the concept of whole shares and instead uses the exact percentage chosen when setting up the portfolio.

Rebalancing: Rebalancing is conducted on either a quarterly or monthly basis,as selected by the creator of this report. Weights may drift away from the target allocations between rebalance periods

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What I'm doing with my own clients . . . who are ESG involved

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- I have a small set of clients
- An even smaller slice . . . expects ESG sensitivity
- I'm unusually forthright with them about
  - The industry's misleading story-telling
  - How difficult it is to measure
  - It's even more difficult to execute
  - They and I need to engage on . . . what's important to them . . . how do they define ESG
  - That I will present honest viable opportunities . . . as they arise, but they are few and far between

Sensible, practical advisor approaches, responses

- **A label**
  - Use one or more of the ESG models being offered by segments of the industry
  - Don’t expect it to work . . . . other than the label, and being ultra-easy to use

- **Custom build**
  - This is seriously time consuming
  - It tailors the solution (which you have to build) to how your client defines (and evolves) their own personal definition of ESG

- **Honest forthright industry products**
  - Julex ESG
  - Others . . . real estate, private debt, electrification, energy-storage . . . all limited partnerships

un film di
SERGIO LEONE
IL BUONO IL BRUTTO IL CATTIVO
SERGIO LEONE
CLINT EASTWOOD • ELI WALLACH • LEE VAN CLEEF
IL BUONO IL BRUTTO IL CATTIVO
ALDO GIUFFRÈ

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It's not easy. You've got to ask and adequately answer *"Why does it exist?"* and *"Why does it work?"* Very few can afford the required calorie burn

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A record level of bad product is appearing. This will undermine ESG's reputation . . . and its appropriate application

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For a 20-year investment, should I use an all-stock portfolio . . . or TAA

Friday

March 24th

11:00 a.m. EASTERN

Important Disclosures

All data and statistics were provided by Global Financial Data, Inc. and NDR, Inc. (unless otherwise indicated in the exhibit)

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