The Modern Investor Guide:

Tackling Sustainable Investing's Most Common Myths

Seeds Investor, LLC is a registered investment advisor

For years, the status quo has dismissed socially conscious investing as the well-intentioned but misguided philosophy of naïve investors. To some, investment decisions should prioritize returns above all else, regardless of personal values that might directly conflict with the investment itself. The idea that investing could or even should serve a dual purpose—to improve both performance and the world—has forever clashed with the "greed is good" cutthroat convictions of Wall Street.

Small voices rarely effect real change, particularly when up against deeply entrenched conventional thinking. As most investors have historically set aside values to prioritize the bottom line, financial institutions until now haven't felt much of an economic incentive to develop better solutions. But amid broad and growing demand, a new generation in particular has begun to push socially conscious investing into the mainstream. Of a Millennial generation that will inherit a $30 trillion transfer of wealth, 86% show an interest in socially responsible investing[1].

Despite this increasing demand, some institutions have a long way to go when it comes to delivering the products, services, and advice that align with personal values. Fortunately, some financial advisors have already adapted to changing preferences, finding more effective solutions for clients.

What is sustainable investing?

So, you've heard of this thing called sustainable investing. Suddenly, it's beginning to appear more frequently in financial headlines, it's been embraced by financial titans like BlackRock[2], and it's definitely become a more common—and often hotly debated—topic among financial minds and all the talking heads on TV.

But what is it, exactly? At its core, sustainable investing means investing in the future. While people may think of sustainable investing simply as a way to empower better performers when it comes to environmental and social issues, proponents—and research—suggest that such factors are inherently connected to long-term performance. By focusing investment analysis on factors that contribute to the likelihood of future success, investors can feel more confident that they're putting capital into investments that will actually exist and thrive in that future.

Meanwhile, these types of strategies to a large extent have become politicized, with opponents conflating different investment approaches and even claiming that such strategies inevitably underperform benchmarks. And at the same time, even supposed proponents confuse investors, pushing products with misleading labels, a practice known as *greenwashing*.

Faced with confusing options, ambiguity, and sometimes misleading headlines, some investors—and financial advisors—feel lost.

This brief Investor Guide explores some of the most prominent misconceptions about sustainable investing so investors can find more confidence in their sustainable investment decisions.

Misconception 1

Sustainable investing is just for left-wingers

As a topic up for public discussion, sustainable investing comes with some political touchiness, mostly thanks to its inherent interconnection with the broader climate science debate. Just as our overall political climate has pulled us further apart and closer to the poles of our partisan spectrum, the divisiveness surrounding socially conscious investing has created the appearance of two camps in total opposition. And just as in our political discourse, fundamentally important nuance falls to the wayside.

Something so innately complex as sustainable investing deserves a far deeper look from all sides than politicization allows, which means reasonable proponents must work even more intently on communicating its important distinctions that matter most to every investor.

Many socially conscious investment critics often unknowingly conflate various socially conscious investing approaches into one, formulaic methodology. Often, these critics erroneously narrow the definition down to what's known as ***socially responsible investing (SRI)***, whereby an asset manager prioritizes specific values ahead of performance by excluding certain sectors, companies or products from a portfolio. This often manifests in the removal of climate-unfriendly companies, thus connecting what's otherwise a straightforward investment methodology to a particular political leaning.

Since blindly screening out entire industries could in fact create unintended risks and performance downside, critics more partial to fossil fuel protectionism tend to argue that socially conscious investing fundamentally goes against the fiduciary role of an investment manager. While that may arguably hold true for a hardline SRI methodology, many other socially conscious investment approaches can create a much more meaningful balance between personal values, risk, and performance. A top-down ESG strategy, for example, prioritizes returns as well as risk aversion by investing in companies that rate highly in environmental, social, and governance (ESG) factors.

Any investor can therefore create portfolios that align not necessarily with political identity but with basic moral and ethical values that all (or at least most) investors hold.

The Takeaway: Pulling back the political lens means any investor can align a portfolio with moral and ethical values, possibly earn better returns, and, at the same time, create positive change in the world.

Misconception 2:

Every sustainable investment approach is the same

As investors expressed different socially conscious preferences over time, a few industry approaches emerged, including environmental, social, and governance (ESG), socially responsible investing (SRI), and impact investing. However, varying definitions have confused not only investors, but the professionals trying to provide advice. While an ESG strategy prioritizes returns by investing in companies that rate highly in ESG factors, traditional SRI puts specific values ahead of performance by excluding certain companies from a portfolio. Meanwhile, impact investors predominantly seek for-profit companies making a positive impact beyond the bottom line.

Unfortunately, much of the industry is either unaware of these different definitions or conflates them into one, formulaic approach for any client who shows interest in socially conscious investing. Such a singular view overlooks the important purpose behind the different approaches and effectively dismisses the specific values and preferences of individual investors. Meanwhile, even those that recognize these nuances still tend to assign socially conscious clients to just one of the basic approaches, even when a more complicated blend of the three is more appropriate.

The Takeaway: Investors seeking values-based investing options should recognize that not all options are created equal. Find an advisor who can explain the nuances and deliver a strategy that matches your needs.

→ Misconception 3:

Sustainable investing inherently underperforms

Since many for years believed that the screen-out SRI approach represented the entirety of socially conscious strategies, conventional wisdom suggested doing good unavoidably meant doing damage to portfolio returns.

Surprisingly, both naysayers and proponents have perpetuated this narrative as many of those most inclined to invest for good have also assumed the necessity of such a trade-off. And yet a closer look shows that socially conscious investors can not only perform in line, but may in fact outperform strategies that don't make certain socially conscious considerations.

Beyond traditional financial analysis, ESG integration goes deeper into more fundamentally important aspects of a company that influence its long-term viability and therefore the stability and growth of its stock price. In fact, numerous studies have shown that ESG analysis can benefit performance in part by limiting potentially catastrophic company-related ESG risks.

Sustainable funds outperformed their conventional peers in 2019, with 35% finishing in the top quartile of their Morningstar categories and 66% in the top half.[3]

The Takeaway: Investing in a way that aligns with your personal values does not inherently require a trade-off for investment performance. In fact, growing data continues to show that ESG integration can add investment "alpha" relative to benchmarks.

Misconception 4:

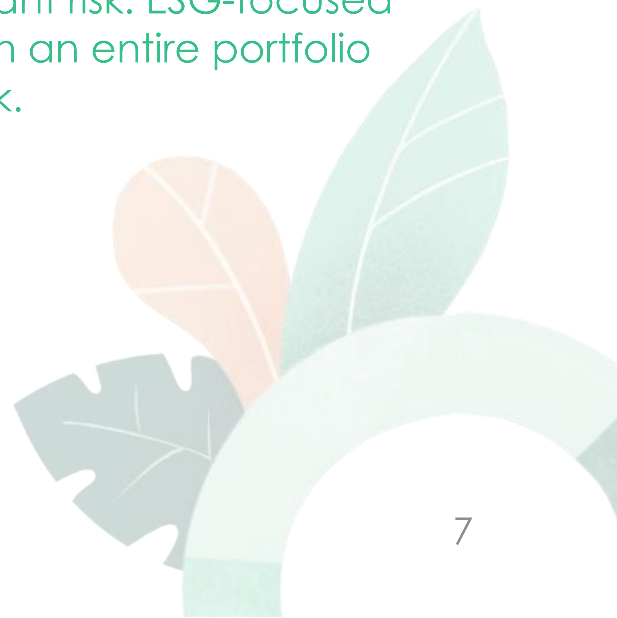
Impact investing is most impactful

Since socially conscious investing serves such an important purpose, steadfast proponents sometimes advocate for a somewhat misguided approach that only seems most effective, whereby investors must not only divest from companies with which they don't agree (i.e. traditional energy companies), but also invest solely in companies specifically structured to do good in the world beyond the bottom line (i.e. solar companies). This method—a combination of an SRI screen-out and what's specifically known as impact investing—represents a higher-risk strategy that very few investors can afford to follow, thus serving up an easy target for skeptics.

However, investors can uncover more nuanced ESG approaches that balance personal values with financial metrics like an investor's risk tolerance and time horizon. Doing so allows more of the investor population to take part in broader change, effectively democratizing the influence of our collective dollars.

Instead of hand-picking higher-risk impact companies in specific impact sectors (i.e. renewable energy), ESG investors can create entire portfolios that balance risk and invest in highly rated ESG companies in all industries. Rather than just some impact investors empowering a few impact companies, a nation of ESG investors can instead hold all companies in all industries accountable to higher standards.

The Takeaway: While impact investing proactively supports companies directly improving the world, investing in such companies often means taking on significant risk. ESG-focused strategies, however, allow investors to align an entire portfolio with values without taking on too much risk.



Misconception 5:

Labels equal reality

Unfortunately, assumptions about the largest segment of our population—Millennials—has resulted in cookie-cutter investment products that put sizzle over substance. Hundreds of mutual funds and exchange-traded funds (ETFs) now showcase some sort of ESG label, often without any clear criteria as to what a company must do to rate highly in ESG. Many ESG-labeled funds also include holdings that score highly in one ESG factor like environmental standards but fail miserably in social or governance factors. For example, one well-regarded ETF includes a company with a now infamous corporate mandate to defraud its customers.

In defense of the industry, it faces an incredibly difficult task in trying to create scalable solutions to an elusive problem as every investor prioritizes different values. And beyond values, advisors have a fiduciary duty to create diversified portfolios that also reflect a client's financial objectives and risk tolerance. Technology will likely play the most important role in this endeavor as digital platforms emerge that can determine each investor's values and create completely customized portfolios that still provide appropriate asset allocation and strong performance.

The Takeaway: Supposed ESG investment products increasingly include misleading labels that don't really reflect the underlying strategy, a practice known as *greenwashing*. Knowledgeable financial advisors can explain the differences between what a label says and what the product does.

We hope that this Investor Guide will help you recognize misconceptions and make a more informed decision when it comes to values-based investing. Good luck as you keep moving forward!

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Footnotes

1. Morgan Stanley. "How Younger Investors Could Reshape the World," Jan, 2018.
2. BlackRock. "Larry Fink's Letter to CEOs," Jan 2020.
3. Morningstar. "Sustainable Funds U.S. Landscape Report," Feb 2020.