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ESG and Sustainable Investing

A Discussion with David Callaway and Robert Powell, CFP®



INVESTMENTS & WEALTH INSTITUTE®

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Investments & Wealth Monitor (IWM) wanted to discuss investors' understanding of environmental, social, and governance (ESG) and sustainable investing, how to accelerate advisor and client education in this area, and how advisors can differentiate themselves. We invited two industry leaders to talk about this important topic.

David Callaway is founder and editor-in-chief of Callaway Climate Insights. He is former president of the World Editors Forum and former editor of USA Today.

Robert Powell, CFP®, is editor of the Retirement Management Journal, and editor and publisher of Retirement Daily on TheStreet.

Investments & Wealth Monitor Editorial Advisory Board Chair Tony Davidow, CIMA®, moderated the discussion.

Davidow: Dave, do you think investors really understand ESG and sustainable investing, or is this a topic that we need to do more work on?

Callaway: I don't think investors truly understand it. I'm not sure that fund managers and financial advisors truly understand it, or even the people who have put it together truly understand it. ESG is a phenomenon. It's not a stock class or an asset class. It's not a theme. It's a way to do business. And ESG is so broad that it really covers almost every aspect of a company's business, and it's going to require almost a revolution in how companies



David Callaway



Robert Powell, CFP®

work for their stakeholders. We're in the early innings of trying to understand what ESG is and how it applies to business and to investing.

Davidow: I'll turn to you Bob. IWM has published multiple articles about sustainable investing and ESG over the past couple years. We've tried to address the topic from multiple perspectives, but even among the editorial advisory board there are disparate views about what ESG is and what the results tell us.

What are your thoughts about what you've seen and heard from advisors? Do you have ideas about how we can accelerate the education on this important topic?

Powell: From my perspective, there's this top-down push on the part of institutional investors to take hold of the ESG theme, however you define it, and make it part of what they do. I have in my hand the current issue of *Pensions & Investments*. I can't flip a page without there being a headline about ESG. "New York fund takes long road on fossil fuels"; "Investors grapple with climate risk on physical assets"; "BlackRock has good year, encourages climate action." So, from the top, the institutions

are definitely there. From the bottom, I think investors are embracing ESG even though they may not understand that it's about climate change or human rights or labor issues.

I'll give you this example. I hired an intern this past year, and one of the assignments I gave her was to open a Roth IRA [individual retirement account] and invest in something. What did she do? She picked an ESG fund without necessarily knowing anything at all other than it sounded good, like, "I'm doing good." So that brings me to your question. According to the research that we published in IWM by Cerulli Associates, advisors don't think their customers want ESG—but they do. And advisors don't want to talk about ESG because they think it's a political issue. They think it's a liberal, progressive issue, and it's not necessarily.

So, we have a long way to go to help advisors, and I think advisors are overwhelmed with the amount of information that they're getting. They're having trouble, I think, making sense of what ESG is and how they should educate their clients. The first order of business is to provide advisors with education that allows them to talk competently with their customers.

Davidow: I think part of the confusion comes from people not distinguishing between SRI [socially responsible investing]—negative screening—and ESG, which is a relative screening methodology. But there's a false narrative that ESG is just for big institutions, women,

and millennials. The other thing we often hear is that ESG funds come with a significant haircut relative to unconstrained funds. How can we help address these two false narratives with advisors and investors?

Callaway: I can see where the first false narrative might come from. When you think of environmentalists, well, that's liberal progressives. You think of social, that's millennials. You think of governance, often that covers getting more women and minorities on boards of directors. But the bigger false narrative is the haircut. Yes, a lot of the so-called ESG stocks have been having a tough time in early 2022. But folks who were buying ESG funds two years ago were beating the market handily, even for parts of 2021. It's because Microsoft and Amazon and Facebook [now Meta], all these tech stocks, didn't necessarily do a lot of environmental or social or governance good, but they walked the walk. Now the SRI premium cut—that's a real thing, we can look back on history and see that. But the real proponents of ESG, the folks who understand it the most, make an arguable case that a company that follows the principles of ESG will perform better over the long run. We just don't see that in the daily, weekly, and monthly durations of the stock market.

Davidow: Bob, you and I have spoken quite a bit about including ESG in retirement funds. Let's not get into the politics, but don't we want to provide retirees with a robust menu of options? How do we educate retirees so they can make better-informed decisions? Who should take the lead in educating?

Powell: I think we're getting there in a number of ways. Obviously, asset managers who are offering ESG inside their target-date funds or on their menus are attempting to educate.

But we're also noticing that a number of plan sponsors are creating brokerage windows in response to plan

participants' demands for ESG funds that may not exist in the current lineup. So, some plan sponsors are offering plan participants a brokerage window to get direct access to the ESG funds that they want. This is going to happen, whether or not an asset manager is part of a mutual fund lineup that offers an ESG fund. Companies are going to open up brokerage windows and give plan participants access to ESG funds, and I don't think the DOL [Department of Labor] or anyone's going to be able to stop this trend.

But as Dave mentioned, ESG funds were outperforming for much of 2021, up until the tech stocks got hit. Often I hear people ask, "How is it that a company like Exxon gets through an ESG screen when it does X poorly with governance and environmental but does Y really well with S?" Maybe what I envision is just E-only funds, or S-only funds, or G-only funds. I could see a separation of E, S, and G that could handle the dissonance that comes up when you try to think about putting ESG all under one roof.

Callaway: That would help relieve some of the confusion. You're right, if you call up a list of top ESG stocks, you find plenty of oil companies and banks, and the argument is, "Well, they're investing in renewable energy, so we're including them in the ESG bucket." If you're a retirement advisor you may be avoiding ESG, but almost any fund in the market is going to have stocks that fall into that category. So, I think that this debate is going to slowly go away as ESG becomes more understandable.

Davidow: Dave, that's a really important issue. SRI, the first generation, was negative exclusionary screening, which meant you avoided oil, tobacco, sin stocks, or whatever else you wanted to exclude from your portfolio. ESG is relative screening, which means that you may own Chevron because its ESG score is higher than Exxon and other oil giants. In other words, if Chevron scores

higher on ESG, it receives a higher weighting in a portfolio.

Bob, I think you're right that it would be interesting if we could isolate the E, S, and G exposures. Also, I think it would be very helpful for advisors and investors if we could provide greater transparency on how each company scores across the E, S, and G pillars. For example, Tesla may score very high on its environmental impact, but its governance score could be low based on the independence of its board. The bottom line is we need to understand how a company ranks across the E, S, and G pillars.

Powell: I would add too, Tony, that in *Pensions & Investments*, they were talking about how portfolio managers pick the companies for their portfolios. Managers oftentimes will use the data providers, but data providers don't necessarily agree about how they come up with their recommendations or their rankings. Managers are always doing more internal research on top of the purchased research to figure out which stocks to buy. So, there are two screens. There are the data providers and then the managers' internal research. And we need more transparency around what the data providers are doing, how they're ranking, how they screen in or screen out companies.

Callaway: That business is maturing as the data gets better and more cohesive. But Tony, I think you hit the nail on the head when you asked, "What is ESG?" It's a score. It's a score of how a company performs among many criteria, including profit and revenue. If it's viewed as a score, I think that really helps investors get their heads around where it goes in their decision-making.

Powell: I'd be curious to see what happens when the SEC [Securities and Exchange Commission] or the European agencies mandate ESG reporting. What does that look like and how does that change things?

Davidow: Bob, that's where I was going to take this discussion. It seems like our European counterparts are ahead of us in embracing ESG, and a lot of institutions are asking for more disclosure about a company's ESG score. So, I wonder, what is next on the regulatory front? The SEC and the DOL are looking at the inclusion of ESG funds in retirement plans. Will they come out with standards and disclosure requirements?

Callaway: Our sources are saying we'll do that in 2022, maybe, and that the Europeans will find a way also. We've seen the gradual coming together of the institutions that measure ESG metrics, the Sustainability Accounting Standards Board.¹ In the EU [European Union], the International Sustainability Standards Board was introduced late last year. That is going to bring all of them together in a way that will allow, potentially, countries and regions to use their own cultural scores but with broad guidelines that everyone agrees on.

Davidow: One takeaway here is that advisors can't put their heads in the sand on this issue. And Bob, you're right that multiple studies have shown that investors want advisors to provide ESG education. The CFA Institute, and studies by several asset managers, have shown that investors want education and feel their advisors should be educating them. The same research often shows a lack of interest and willingness from advisors. This is a complex topic. But I think a lot of an advisor's value is serving as an educator, especially about complex topics like ESG.

Dave, there was a lot of hype last year about COP26, the United Nations Climate Change Conference.² Did anything happen there that was groundbreaking? What were the key takeaways?

Callaway: Good question Tony. These global conferences, which may or may not be outdated in today's digital world,

always tend to set themselves up to disappoint. And then, as the months go by and you look back on them, you realize that there was more progress made than you initially thought. But the problem is, the media latches onto the big headlines, and for COP26, which was held in Glasgow last fall, the main headline was that, even though everyone knows coal is the most destructive fossil fuel out there, nobody could get a firm commitment among the nations of the world to stop using it or even agree on a timeframe for when they would stop using it.

Indeed, there was more coal produced in 2021 than in recent years. China and India put the kibosh on an 11th-hour deal to help U.K. Prime Minister Boris Johnson and U.S. Climate Envoy John Kerry save face by saying, "Well, we'll try to reduce coal emissions." That's not even good enough, but the headlines basically blasted it as a farce.

Then you have (the young Swedish climate protection activist) Greta Thunberg out there with the protestors, and it's easy to say it was a failure.³ But some progress was made, particularly in the financial sector. Mark Carney, a Canadian economist and the former Bank of England and Bank of Canada governor, who has taken a big role in organizing the financial world around climate change and ESG, made some serious progress in bringing groups of investors together. This could be the next step toward the financial world coming to at least some sort of agreement on disclosure and reduction and stress. And like I said before, the metrics groups came together and established an international sustainable accounting standards board, which essentially will suck up all of the others and become the main driver of sustainability metrics going forward. So that's progress. It's not sexy or grabbing headlines, and it didn't move any markets. But when we look back in a few years, it will look like significant progress.

Davidow: That's encouraging. Bob, anything to add?

Powell: I think it's a fragile win. I think the recognition that we need to do something about climate change is evident, but it's slow going. For countries like China and India, the big issue is how we do it in ways that don't harm the economy. How do we replace coal? With nuclear? Germany is shutting down its nuclear capacity, which many people see as the energy source best suited for a world where you have to reduce carbon emissions.

Callaway: These are all good points. And meanwhile, in a world that says, "Let's go slow," we're getting climate disasters. We have devastating wildfires—in the middle of winter. We have record heat, killing people, record storms and floods. The effects of climate change are not moving slowly, so we're going to have to move faster. And that's why I'm encouraged by at least some of the steps that the financial industry is taking, which seem to be happening with a little more of a sense of urgency than what we're seeing from governments.

Powell: Look at what BlackRock Chief Executive Officer Larry Fink has done. As leader of perhaps the largest asset manager in the world, Fink is setting an example. He says we don't have to vote the proxy, we can pressure companies in other ways to do things that are aligned with our ideals. So that kind of power is impressive. It's the ability to sway the rest of the financial industry by virtue of your asset size and your words.

Davidow: Larry Fink's recent statement regarding "stakeholder capitalism" garnered a lot of attention. Fink stated: "Stakeholder capitalism is not about politics. It is not a social or ideological agenda. It is not 'woke.' It is capitalism, driven by mutually beneficial relationships between you and the employees, customers, suppliers, and communities your company relies on to prosper. This is the power of capitalism."

Larry Fink, JPMorgan Chief Executive Officer Jamie Dimon, and the leaders of the Business Roundtable have spoken out about a company's role in leading change.⁴ Given the slow rate of change of government, should we expect the government or the private sector to lead the change?

Callaway: Well, if you expect either to do it themselves, you're going to lose your bet. They must do it together. But I think the financial industry's moving faster because Jamie Dimon and Larry Fink and the like realize that the risk of climate change is their risk. There was something like a couple hundred billion dollars in insurance losses last year. This is climate change. I think Fink said a couple years ago: Climate risk is financial risk. Governments also have realized the dangers that the climate presents to citizens, but by their very nature governments are less able to move as fast. China could move fast if it wants to, but it doesn't want to. Countries like the United States or other democratic governments have different views, making it a lot harder to do. Europe is finding that in Brussels as well. So, my belief is that the financial industry has to at least try to lead. But the governments are ultimately the ones with a lot of the money that can help.

Powell: Governments are good at reacting to emergencies but maybe not to long-term trends. So, I'm not hopeful in some regards because it's not catastrophic yet.

Callaway: It's hard to be hopeful when you see these disasters and you see governments arguing and bickering. But what makes me hopeful is to look at things like the electric vehicle revolution, or gains in solar power and wind power. Some of that is government-subsidized, but a lot of it is just entrepreneurs backed by financiers changing the world, just like the iPhone changed the world. I put

a lot of stock in humanity's creativity in new technologies.

Powell: As long as we can mine enough cobalt and lithium, we'll be fine.

Davidow: Dave, I agree with you on two key points that you made there. I believe that the private sector is more likely to take the lead on this—they are nimbler and can affect change more efficiently. They can lead by example in the way they conduct business, the way they engage their communities, the way they embrace sound business practices, and the way they address diversity and inclusion. I also agree that we need the government engaged on this topic.

So, in light of the Russia-Ukraine conflict, and the intersection of energy and ESG, does this change your view regarding the pace of change for adopting ESG? Is there a conflict between our energy policy and ESG investing?

Callaway: It obviously changes the timeline because we are now in an oil surge, unfortunately. But the principles and the ideas behind ESG transition—especially how it affects individual investors—remain the same, in my opinion. Oil will come down again, there's no need to be chasing it for retirement accounts.

Davidow: Let us close with this final question. I think advisors can play a critical role in educating investors about the different screening and weighting methodologies, and the merits of ESG strategies in client portfolios. How can advisors take this challenge and turn it into an opportunity? How can they lean into this issue and deepen their client relationships?

Callaway: A financial advisor's fiduciary duty is to do the best for clients. That means to keep clients financially comfortable while handling client expectations that their investments are going to do good in the world, will be part of

the ESG revolution, to some extent. So, I think you're right, Tony. Investors need to be educated, and they need to have their expectations managed to some degree, if this is going to continue to be a theme for investors.

And that falls to financial advisors. They're the ones who need to help bring the investor class to the next level, to get them past the meme stocks and some of the crazy stuff going on in the market. And make sure that ESG is not regarded as a fad but that it is the future of capitalism to some degree. So, a lot of pressure, a big challenge, but how the best ones do it will dictate where the money's going to come from to finance some of these solutions.

Powell: So just a couple thoughts. One is that the need for advisors to differentiate themselves is greater now than ever before. It's a world where many advisors are just undifferentiated. Either they don't have a niche, they don't have an expertise, they use the same models as the advisor down the street, or they use the same asset managers. So somehow, some way, they need to differentiate themselves. One way to do that would be to become an ESG expert and to go out to their clients proactively and say: "The world is changing. It starts with maybe BlackRock and COP26, and we need to revisit your portfolios, make adjustments, and continue to do well but also do good, for yourself and your children and your grandchildren. We're not going to sacrifice returns, but we want to align your investments with where the world is going or where the world should be going."

That kind of messaging, I think, could resonate with clients. Think about the advisors who work with ultra-high-net-worth individuals, where they have the opportunity to say, "Look, we want your money to be aligned with your values." Well, why should that be any different for the average investor? Should it be only the ultra-high-net-worth investor who gets their money aligned with their

values? Advisors are in a position to say: “What are your values? Here are investments that are aligned with them.”

Davidow: Thank you both. I agree; I think ESG is a huge opportunity for advisors to differentiate themselves, to lean into this challenge and to really change the relationship that they have with clients. Rather than their value-proposition being tied to outperforming the market, they can assist clients in

aligning their values and purpose with their portfolios.

Thank you for sharing your views and opinions. We’ve covered a lot of ground here, and I know that our members will benefit from your insights. ●

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ENDNOTES

1. See <https://www.sasb.org/>.
2. See <https://ukcop26.org/>.
3. See https://www.ted.com/speakers/greta_thunberg.
4. Business Roundtable is an association of chief executive officers of America’s leading companies working to promote a thriving U.S. economy and expanded opportunity for all Americans through sound public policy (<https://www.businessroundtable.org/about-us>).



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