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ENVIRONMENTAL, SOCIAL, AND GOVERNANCE INVESTING

Time to Strive for More

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Shareholder activism used to mean divestiture—selling ownership shares out of protest. Divestiture blossomed in the 1980s under the leadership of Rev. Leon Sullivan, the only African-American board member of General Motors, which at the time was the largest employer of South African blacks. In 1977, almost 30 years after the beginning of apartheid, Sullivan set forth new corporate standards for GM that were quickly adopted by other U.S. companies with South African operations. South Africa refused to recognize the "Sullivan Principles," but more than 100 major employers left South Africa; the country eventually abolished apartheid in 1991.[1]

These timelines would horrify today's up-and-coming investors, the on-demand generation known as millennials. But shareholder activism today continues to build on the success that past activist investors had by engaging at the corporate board level.

LONG-TERM SHAREHOLDERS AS ACTIVISTS

Long-term shareholders have had these discussions for years. These are not the shareholders who are in it for a trade, who are rarely interested in social responsibility—or for that matter the future of the company. Two of the world's most respected long-term shareholders are Benjamin Graham and Warren Buffett, both well-known for their "value investing." Graham wrote *The Intelligent Investor*, a timeless investment book. He's less known for his work as an activist, but Buffett, his protégée, is better known for sparring with companies, management teams, and boards of directors.

For most of the world, however, active investing has been superseded by the move to index or passive investing. Today more than $5 trillion in the United States alone is invested blindly in broad indexes. These investors, or those that organize and run funds and implement the discipline of passive investors, are destined to be the longest-term investors. In years past, this was the claim of the private equity community. Now millennials, the largest generation in U.S. history, have taken up the cause of transparency and social change. Millennials don't control huge sums of money yet, but baby boomers are retiring and consuming their savings, and ultimately they will hand off the lion's share of their assets to millennials, who will assume the mantle of disruption from their boomer forebears.

And already the terminology has changed. Twenty years ago, the term "socially responsible investing" (SRI) reflected the interest of many to invest with their values, driven by their beliefs (some religious in nature) and focusing on issues including the environment, tobacco, arms, and birth control. Today the terminology has evolved to "environmental, social, and governance" (ESG), reflecting the demands of the millennial generation. Today even the staunch bulge-bracket firms have endorsed this trend toward ESG, a sure measure of its growing acceptance within the mainstream.

For example, Morgan Stanley's website describes its new ESG solutions:

> *With Millennials taking the reins as the largest demographic in America—by 2020, one in three U.S. adults will be a Millennial—the growing interest in Investing with Impact among this cohort cannot be ignored. However, most sustainable investing opportunities are perceived to cater to individuals with significant wealth, while Millennials are still early in earning years. In response, Morgan Stanley is launching the Impact Access Model Portfolios to provide access to diversified investments with reduced account minimums.*[2]

Many of the companies that have grown with and served the millennial generation, however, stand in direct conflict with millennial values. Rather than allowing all investors an opportunity to voice concerns using the one share, one vote standard, founders of companies such as Snap, Google, and Facebook have super voting rights. For example, Mark Zuckerberg owns roughly 30 percent of all Facebook shares, but due to his super voting rights he controls 60 percent of the shareholder vote, allowing him complete control of the company. The common argument favoring super voting rights is that many shareholders are short-term oriented, and founders do not want their long-term vision diluted by short-term demands. Snap Inc., parent company to SnapChat, used its market dominance to defy all standards and declined to issue any voting rights at all to its public shareholders. Early investors Fidelity and T. Rowe Price paid the price as Snap's shares plummeted by more than 40 percent post-initial public offering. The best governance was exhibited by Standard & Poor's, which refused Snap entry into its S&P 500 Index for thumbing its nose at shareholders.

Meanwhile, index leaders BlackRock and Vanguard have built impressive teams to research and interact with companies, expressing and reporting on ESG issues. These same companies also have made a serious commitment to building teams to analyze and engage with activists, because they are truly the long-term shareholders—owning the stock as long as it is in a given index. Others are building more limited ESG offerings, screening companies and entire industries for ESG alignments. More screens are becoming available through firms such as Morningstar and activist shareholders such as As You Sow, which offers sites that rank funds' exposure to carbon and tobacco among others. All are virtuous, but none of these groups has yet made the leap into the boardroom; all have limited their work to the voting of proxies.

SHAREHOLDER ACTIVISM

In his book *Dear Chairman*, hedge fund manager Jeff Gramm tells us that shareholder activism has existed for 400 years.[3] In the 1600s, shareholders and directors of the Dutch East India Company clashed over control issues, and shareholders mobilized public opinion that discouraged investors and resulted in change. In the 1800s, U.S. robber barons controlled booming railroads, ports, and banks and thus entire cities and states, not to mention the lives of their employees, customers, and clients. But until the 20th century, U.S. public shareholders had very little information about the companies they owned. As an example, from 1900 to 1940 only seven shareholder actions were documented. One of the more consequential was in 1911, when brokerage firm J. S. Bache (the predecessor of Prudential Bache) sought board seats in Central Leather Company to compel the company to report financials on a quarterly basis.[4]

Seven years before writing his first book, *Security Analysis* with Steven Dodd, Benjamin Graham identified a company trading at a discount to its free cash. Graham set about to control enough shares to join the board of Northern Pipeline, one of nine pipeline companies that had comprised Standard Oil before the U.S. Supreme Court ordered its break-up 15 years earlier. Young Graham attended his first board meeting, certain that after more than a year of work he would finally release shareholder value. At the end of the meeting he made his proposal. No board member seconded it, and the meeting was adjourned. Graham learned that one board seat offered little opportunity to promote change. But not to be outdone, he was back a year later with enough votes for a second seat. Quickly thereafter Northern Pipeline began distributing excess cash to shareholders.[5]

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SHAREHOLDER RIGHTS

With this and other small wins, shareholder rights began its climb into public equity. For example, activist James Peck bought stock in Greyhound Company and later in the Grant's, Kress, and McCrory's five-and-dime stores in order to force discussion at shareholder meetings about segregation.[6] Later, as apartheid continued in South Africa, the Stevenson-Wydler Technology Innovation Act of 1980[7] brought direct action to GM, opening the door for hiring and better pay for black South Africans. This act forced GM (the largest employer of black South Africans) to adhere to basic employee rights, or to leave South Africa. Today entities such as As You Sow continue these endeavors around ESG issues, bringing information and engagement via proxy actions and discussions with investors and management.

21ST-CENTURY ACTIVIST SHAREHOLDERS

Today's most successful active managers are activists, such as ValueAct, Pershing Square, and Trian Partners, that have shown that they can invoke change with boards of directors. Like Warren Buffett, George Soros, and Ben Graham, these managers had to earn their stripes, and over time some boards have learned that they can benefit from activist input. Others, however, perceive activism as a threat to board members, and large-scale Wall Street firms such as Lazard, Goldman Sachs, Morgan Stanley, and McKinsey have lined up to protect boards from activist shareholders.

Drawing on the lesson that Graham learned, activists often attempt to elect a full slate of board members, looking to bring their concerns behind hallowed boardroom doors. They don't sell their shares and go away like divestors but rather focus on making a difference.

During the late 1970s and through the 1990s, activists' dominant approach was the leveraged buyout. Although financial engineering may still be a component, activists now are bringing new business plans and perspectives that management and boards may not have considered. This can be a constructive dialogue, similar but not as consuming as the input a management team could get from a private equity buyer. Today, many activist campaigns focus on building the business through better organizational structures and improving the quality of goods and services.

Trian, a $10-billion activist known for engaging with behemoths such as

General Electric, Proctor & Gamble, and DuPont, moved to invoke ESG in April 2018. Trian's website states:

> *Trian believes that environment, social, and governance (ESG) issues can have an impact on a company's culture and long-term performance and that companies can implement appropriate ESG initiatives that increase their sales and earnings ... We believe that the consideration of ESG factors enhances our overall investment process.*[8]

This statement appears to mark a major move for Trian and perhaps for the industry. Since the 1970s, portfolio managers have referenced the Employee Retirement Income Security Act of 1974 (ERISA) and its guidance around fiduciaries and prudence. The courts have not yet taken on the prudence of social causes, but many observers point to the large number of countries that have signed the Paris Climate Accord and the United Nations' Sustainable Development Goals for 2030. Most recently, Jana Partners and the California State Teachers' Retirement System (CalSTRS), collective owners of $2 billion in Apple Inc., demanded that the company address issues of adolescent iPhone addiction.[9]

HEADWINDS FOR ACTIVISM

Just as this movement gets traction, ESG investing is taking some hits. On April 23, 2018, in a move that all but negates past Obama-era messaging, the U.S. Department of Labor (DOL) issued Field Assistance Bulletin (No. 2018-01), which states:

> *It does not ineluctably follow from the fact that an investment promotes ESG factors ... that the investment is a prudent choice for retirement or other investors. [Furthermore, ERISA fiduciaries should not] routinely incur significant plan expenses to, for example, fund advocacy, press, or mailing campaigns on shareholder resolutions, call special shareholder meetings, or initiate or actively sponsor proxy fights on environmental or social issues relating to such companies.*[10]

DOL's position is supported by a CalSTRS independent study that evaluated CalSTRS investment restrictions and divestments from 2000 through 2017 and found they cost the teachers' retirement fund more than $5.8 billion.[11] As of May 31, 2018, CalSTRS was a $224.9 billion fund, so before compounding, ESG efforts cost it more than 2.5 percent of its assets.[12] That's significant, because as of the fiscal year ending June 2017, CalSTRS was $97-billion underfunded.[13] CalSTRS now favors engagement over divestment, but due to political pressures it allows divestment as a last resort.

Another California retirement fund, the California Public Employees' Retirement System (CalPERS)—which is the largest U.S. pension plan other than Social Security—also has been criticized for underperformance due to ESG investments, notably by the American Council for Capital Formation (ACCF). ACCF suggests that CalPERS' $138-billion deficit is due primarily to its focus on ESG; ACCF states that four of CalPERS' worst-performing nine managers were ESG focused.[14]

Indeed, ESG restrictions leave portfolio managers with smaller pools of investment choices. From an asset allocation perspective, this leads to sector limitations for investors in public equity. The market cap for ESG portfolios is almost always less than the S&P 500, because multinationals usually have diverse business lines that often trigger a screen.

The most successful ESG mutual fund is Parnassus Core Equity. According to Morningstar, Parnassus has underperformed the S&P 500 consistently by more than 100 basis points, but this is not surprising considering its portfolio restrictions (see tables 1 and 2).

Parnassus had triple the exposure to basic materials but only two-thirds the S&P 500's holdings in financials and 20 percent of the S&P's holdings in energy (see figure 1). It also was more than 60-percent overweight in health

Table 1

PARNASSUS CORE EQUITY (PRBLX)

History (5/31/2018)	2013	2014	2015	2016	2017	YTD
PRBLX	33.98	14.49	-0.55	10.41	16.58	1.31
S&P 500 TR USD	32.39	13.69	1.38	11.96	21.83	2.02
Category (LB)	31.50	10.96	-1.07	10.37	20.44	1.18
+/- S&P 500 TR USD	1.59	0.81	-1.94	-1.55	-5.26	-0.71
+/- Category (LB)	2.48	3.53	0.52	0.04	-3.86	0.13
Annual Report Net Expense Ratio	0.87	0.87	0.88	0.87	0.87	_
Turnover Ratio	17	14	27	23	25	_
Rank in Category	28	11	49	53	88	53
Fund Category	LB	LB	LB	LB	LB	LB

PRBLX return as of May 31, 2018; S&P 500 TR USD return as of May 31, 2018; Category LB return as of May 31, 2018

Table 2

PARNASSUS TRAILING TOTAL RETURNS (PRBLX)

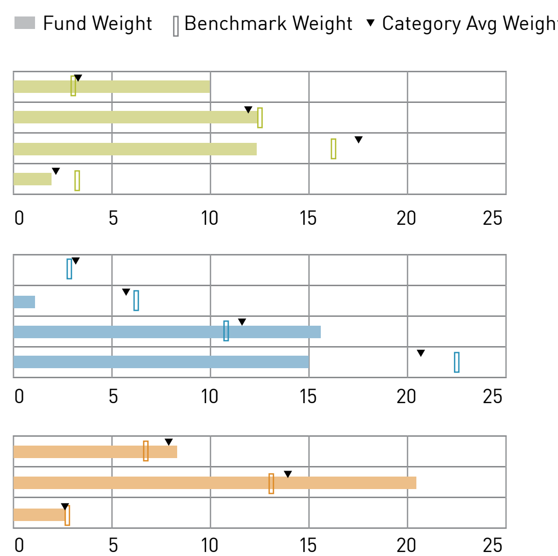
Daily/Monthly/Quarterly										
Total Return % (6/13/2018)	1-Day	1-Week	1-Month	3-Month	YTD	1-Year	3-Year	5-Year	10-Year	15-Year
PRBLX	-0.18	0.43	2.49	1.24	4.58	13.58	10.48	12.14	10.17	9.94
S&P 500 TR USD	-0.40	0.15	1.95	0.86	4.73	15.96	12.15	13.47	9.73	9.35
Category (LB)	-0.38	0.18	1.97	0.65	3.85	14.46	10.18	11.83	8.71	8.66
+/- S&P 500 TR USD	0.22	0.28	0.54	0.38	-0.15	-2.38	-1.67	-1.33	0.43	0.59
+/- Category (LB)	0.20	0.25	0.52	0.59	0.74	-0.88	0.30	0.32	1.45	1.27
Rank in Category	8	16	19	25	38	66	53	55	9	8

PRBLX return as of June 13, 2018; S&P 500 TR USD return as of June 13, 2018; Category LB return as of June 13, 2018

Figure 1

PARNASUS CORE EQUITY (PRBLX) SECTOR WEIGHTINGS

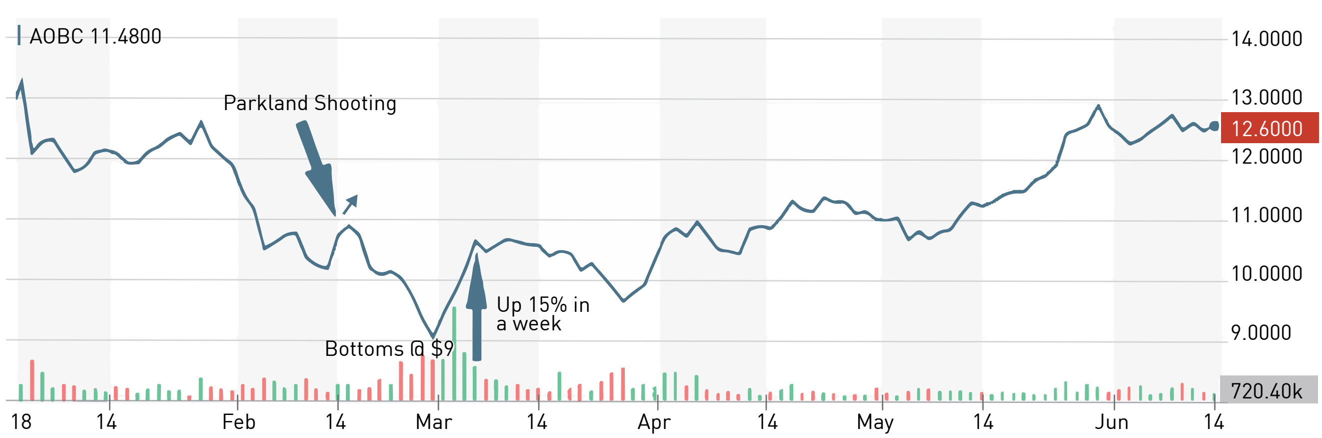
	% Stocks	Benchmark	Category Average
Cyclical			
Basic Materials	10.00	3.02	3.20
Consumer Cyclical	12.46	12.51	11.88
Financial Services	12.40	16.27	17.52
Real Estate	1.93	3.23	2.05
Sensitive			
Communication Services	0.00	2.83	3.07
Energy	1.17	6.20	5.65
Industrials	15.64	10.78	11.55
Technology	15.03	22.68	20.70
Defensive			
Consumer Defensive	8.46	6.71	7.91
Health Care	20.36	13.09	13.91
Utilities	2.56	2.76	2.56



As of April 30, 2018. Sector data is calculated only using the long position holdings of the portfolio.

Figure 2

AMERICAN OUTDOOR BRAND CORP.'S REBOUND



Source: Yahoo Finance

care and more than 40-percent overweight in industrials, but 20-percent underweight in tech. The market cap, though not small, was 65 percent of the benchmark.

THE COST OF BEING POLITICALLY CORRECT

Advisors do daily battle with herd mentality—the pressure to invest when everyone else does and sell when others do, too.

Benjamin Graham was among the first to describe the problem. In *The Intelligent Investor*, Graham wrote about market movements putting great stress on investors—that investors often buy high and sell low, which is a formula for disaster. He reminds us that long-term investors should heed price fluctuations only "to buy wisely when prices fall sharply and to sell wisely when they advance a great deal."

Recent mass shootings in the United States have brought calls for many public funds to divest from firearms manufacturers. But timelines show that arms manufacturers' stock falls following a shooting, then within a month or so rallies back. It takes little imagination to see who pays the price of selling low, opening the door for unconcerned investors to sweep up the discounted shares.

For example, after the Parkland shooting, emotion-driven calls for divestiture led many to sell shares in American Outdoor Brands Corp., manufacturer of the AR-15 assault rifle (see figure 2).

This example illustrates how divestment may make neither financial nor activist sense. Activists who divest give up their rights as shareholders and likely turn their future votes over to those who don't find the company's actions or business problematic.

Yale Investments Office, which has led innovation in portfolio design and allocations over the past 30 years, provides another instructive example. It was one of the first institutions to invest in hedge funds and is a leader in alternative-asset investing, not to mention long-term returns.

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Regarding ESG, the Yale Investment Office states:

> *Yale's approach is predicated on the idea that consumption of fossil fuels, not production, is the root of the problem of climate change. Targeting fossil fuel suppliers for divestment, while ignoring the damage caused by consumers, is misdirected. Given the world's current (and growing) energy needs, modern society could not exist without fossil fuel consumption. Life's basic necessities, including food and shelter, require petroleum-based products and services. Without demand from governments, businesses and consumers, fossil fuel companies would not have a market for their products.*[15]

IN CONCLUSION

Our public equity structure allows for discourse between company management and shareholders. Investors need to understand that they have a voice in the corporate structure, but with that voice comes a responsibility. The press actively promotes divesture but magnifies the problem by widening the moat. As global mutual fund assets reach $50 trillion,[16] it is time for the ultimate shareholders and their advisors to insist on board members who will represent their values in the boardroom.

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ENDNOTES

1. See "The Sullivan Principles," https://www.marshall.edu/revleonsullivan/principles.htm.
2. See "Are Millennials Democratizing Sustainable Investing," Morgan Stanley Voice (March 7 2017), https://www.forbes.com/sites/morganstanley/2017/03/07/are-millennials-democratizing-sustainable-investing/#566c64413362.
3. See Jeff Gramm, *Dear Chairman: Boardroom Battles and the Rise of Shareholder Activism* (New York: HarperBusiness, 2016).
4. See "Central Leather Proxy Fight," *New York Times* (January 31, 1911), https://timesmachine.nytimes.com/timesmachine/1911/01/31/104819344.pdf.
5. See endnote 3.
6. Peck took action in spite of opposition from the National Association for the Advancement of Colored People; he was among the first to use such direct action to create change regarding segregation in the United States.
7. See https://www.gpo.gov/fdsys/pkg/STATUTE-94/pdf/STATUTE-94-Pg2311.pdf.
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13. Randy Diamond, "CalSTRS' Funded Status Falls to 64% as Deficit Grows $21 Billion Following Rate Reduction" (March 30, 2017), http://www.pionline.com/article/20170330/ONLINE/170339980/calstrs-funded-status-falls-to-64-as-deficit-grows-21-billion-following-rate-reduction.
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