CLIFFORD SWAN

THE Investment Counselor

FEBRUARY 2021

WISDOM *for* GENERATIONS

LONG-TERM INVESTORS CANNOT IGNORE ESG

By Daniel J. Mintz

It's no secret that ESG (Environment, Social, Governance) investing is more than a passing fad. ESG investors select companies with a focus on how the business impacts the environment, manages relationships with employees, customers, partners, and communities, and maintains fair and transparent corporate governance. These criteria matter to the investing public, which over the past several years has voted with its wallet. In fact, in the U.S., ESG-focused investment funds have attracted more new inflows than non-ESG funds every year since 2013. Decision-makers across the industry, from allocators advising pension funds to individual investors, are increasingly demanding that their investment managers incorporate ESG considerations into their processes.

ESG investors often consider performance as a secondary objective to aligning their portfolios with their values. A common refrain is that average to slightly below-average performance will suffice, as long as the portfolio is comprised of companies leaving a positive environmental and social impact in the eyes of the investor. However, there doesn't have to be a choice between investing for long-term returns and investing in ESG-friendly businesses.

The concept of ESG investing has existed for decades. In the 1950s and 1960s, several multi-employer pension funds made investments in housing projects and medical facilities to promote social good. In 1980, presidential candidates Reagan and Carter promoted social considerations for allocating pension dollars. The SRI (Sustainable, Responsible, and Impact) Investing Conference was founded in 1990. There were over 150 socially responsible mutual funds in 2001. So why the recent rise in ESG's popularity? As with several other paradigm shifts, multiple factors are contributing. One is the growing national conversation around issues like climate change and the wealth gap. Another is the rise of ETFs, which has led to the creation of numerous ESG-focused funds available to the average investor, albeit with lucrative fees for the manager. Yet another might be generational. With Generation X and Millennials more likely to review their portfolios for ESG impact, it follows that new contributions to their retirement nest eggs are more likely to be allocated with ESG considerations in mind.

Fortunately, those that want strong portfolio performance and those that

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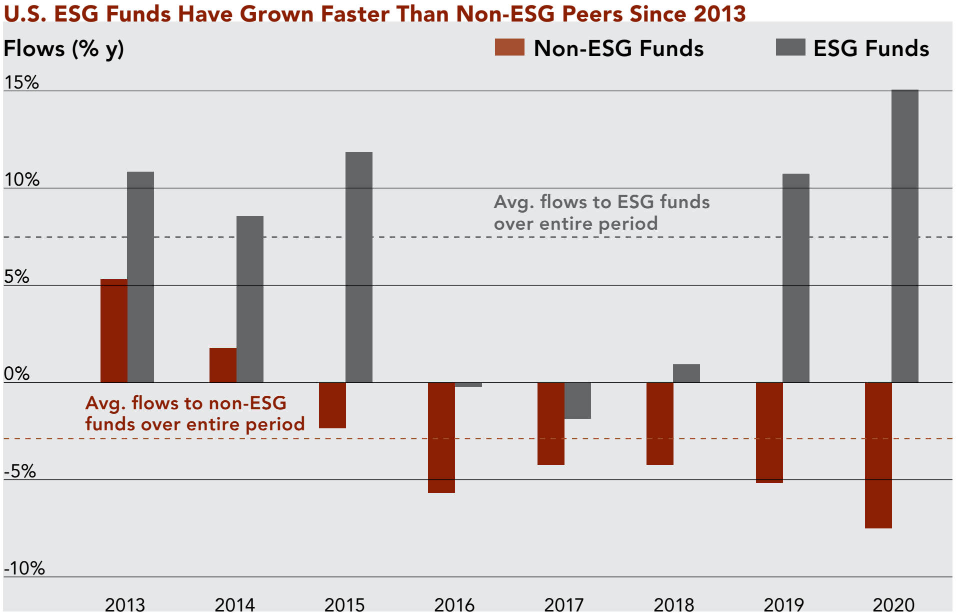
U.S. ESG Funds Have Grown Faster Than Non-ESG Peers Since 2013



Source: EPFR, Barclays Research

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want the businesses in which they invest to benefit multiple stakeholders are often speaking the same language. The common thread is durability.

The most valuable businesses are also the most durable and sustainable. A basic cash flow analysis shows why. If the value of a firm is the present value of its future cash flows, the first few years don't matter very much. Real investor wealth starts to build when companies can produce year after year of growing cash flows far into the future. The market decides which businesses are enduring by assigning them higher valuations, and vice-versa. Print newspaper companies might generate strong current cash flow, but their days of trading at rich valuations are over.

Further to technological obsolescence, what else might impair a business's durability, and therefore its value? ESG analysis attempts to answer this question by asking whether stakeholders other than shareholders stand to lose in the future. The durability of a business model can be called into question if one or more stakeholders (e.g. suppliers, customers, employees, or the community) is consistently being hurt. There are examples everywhere. A manufacturing firm that treats labor poorly can suffer from sub-optimal productivity and a reduced ability to attract talent, which can erode its competitive advantage. Satisfied employees treat customers better, and turnover is expensive. A mortgage broker that puts customers into the wrong loan in order to get a deal done may soon run out of customers. A coal mining firm that doesn't consider the community or the environment may accelerate adverse regulatory responses or competition from new technologies. Each of these situations describes a direct hit to business durability through poor treatment of a stakeholder, and each is value-destroying for shareholders.

Sound long-term investment processes seek to uncover durable business models. It follows that the analysis of any company for inclusion in a long-term portfolio necessarily involves the analysis of whether, and how, multiple stakeholders benefit. At Clifford Swan, we believe that one of our jobs as fundamental investors is to examine the whole "ecosystem" around a company to determine whether it contains elements that might disrupt the business model in the future. Accordingly, much of our work will overlap with that of ESG-focused investors.

If all of a company's stakeholders win, then each has an incentive to grow the firm and keep its foundation strong over time. With all parties aligned, rewarding long-term investments can be found without sacrificing what matters to ESG investors. ◆

IS YOUR PORTFOLIO PREPARED FOR 2021?

By Roger L. Gewecke, Jr.
CFA

Investors in the United States have endured a tremendous amount of turbulence in 2020. We have experienced a large-scale worldwide pandemic for the first time in over a century; a highly contested presidential election; social unrest; a record quarterly drop in gross domestic product; and a sharp, fast decline in stock prices followed by a subsequent rise leading to record highs in most of the major indexes. Against this backdrop, we are often asked, "Where do we go from here?"

As noted investor and author Howard Marks says, "You cannot predict, but you can prepare." How can you work in concert with your investment counselor to ensure your portfolio is prepared for 2021 and beyond?

As a result of the pandemic and the inability of many companies to conduct business during it, gross domestic product dropped 33% in the second quarter, then rebounded in the second half of the year to end the calendar year at negative 3.5%. It is important to note that while some businesses may have been decimated by the pandemic, others thrived, particularly those that serve the "work and stay at home" crowd, such as technology and delivery companies. Those citizens whose paychecks were relatively unaffected by the pandemic should be grateful, as so many others are in businesses that were closed and may not

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reopen even after the largest effects of the pandemic have passed.

For the overall U.S. economy, we might expect an above-average snapback in the first and second quarters of 2021, followed by slower economic growth in the second half of the year and beyond, as the effects of anticipated higher individual and corporate taxes intersect with an increased willingness by the government to stimulate the economy.

In the fixed income markets, 10-year U.S. Treasury bond yields still sit at 1.07%, near historical lows. We are often asked if there are any safe places to earn the types of yields that were seen a few years back. Interest rates on bonds are largely determined by the time to maturity (a bond maturing many years from now generally yields more than a similar bond that matures in a shorter period of time), the credit quality of the borrower, and current and projected inflation over the time the bond has to maturity. In order to earn higher yields, the most likely route is higher inflation, which means the investor would be paying higher prices on the basket of goods that they currently purchase. We would say emphatically that investors should accept lower bond yields at this time, rather than purchase higher-yielding bonds and incurring significantly higher risk with their bond investments. We also believe that investors should hold shorter bond maturities than they normally would, as we are loath to be lending out your money for a longer period of time at these low rates. By keeping bond maturities shorter, an investor might well have the opportunity to reinvest sooner at higher rates and earn a better long-term rate of return.

With stock markets at all-time highs, stocks are trading at the higher end of historical valuation metrics. Stocks also compete with bonds for investment capital, so lower bond rates can justify higher stock valuations, with all other factors remaining equal. To determine a path forward in a market such as this, historical perspective can help.

From 1925 to 2020, the stock market returned a compound annual growth rate of over 9%. Intermediate-term U.S. Treasury bonds returned 4%, a little less than half of the returns for stocks. Those 9% stock returns are not earned in a straight line, however;

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stocks are riskier than bonds, particularly the shorter the time horizon is of the investor. Over the aforementioned time period, the United States endured the Great Depression, World War II, the Korean and Vietnam Wars, the stagflation of the 1970s, the stock market crash of 1987, the internet boom and bust of the 1990s and early 2000s, the financial crisis of 2008, and the current pandemic. Despite all of those things, stock investors earned over 9% per annum over that period - double the rate of bond returns and triple the rate of inflation. Can an investor say with any assurance that the situation our country faces today is as dire as those that we just mentioned?

A look back at history should convince the long-term investor that it has not paid to be a pessimist regarding America and its economy. For nearly 250 years, our free-market system has unlocked the ingenuity of entrepreneurs looking to serve their potential consumers and their needs. Although our economic system does get off track from time to time, it has shown an amazing ability to correct itself and improve our standard of living. The long-term investor should remain sufficiently invested to enjoy the benefits going forward. Oftentimes, the failure to invest is the biggest investment mistake of all. ◆

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