HOUSTON TRUST COMPANY

VIEWPOINTS




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# Socially Responsible Investing

"Socially responsible" and "impact" investing have emerged as important areas of the institutional investment landscape in recent years. A new generation of investors as well as public pension plan, foundation, and endowment trustees have debated the importance of investing capital to achieve socially desirable results. We outline below the approach we take to this topic at Houston Trust Company.

## Philosophical Background

One of the best-known and (we believe) appropriate definitions of investing is contained in Warren Buffetts' Letter to Shareholders of Berkshire Hathaway in 2011:

> "Investing is often described as the process of laying out money now in the expectation of receiving more money in the future. At Berkshire, we take a more demanding approach, defining investing as the transfer to others of purchasing power now with the reasoned expectation of receiving more purchasing power—*after taxes have been paid on nominal gains*—in the future."[1]

At Houston Trust Company, we believe that fiduciaries responsible for investing for the benefit of others—such as professional trustees and investment committees of foundations, endowments, and pension funds—should keep this definition firmly in mind. Indeed, we argue that the preservation and growth of purchasing power is the fundamental objective and duty of those appointed to invest for the long-term benefit of others.

Notably missing from the "Buffett Definition" above is any mention of utilizing investment capital to advance societal or social causes. Our view is that while a keen-eyed focus on investment returns is not necessarily incompatible with worthwhile "social" goals, it is important to not confuse the two, and our approach is to analyze these two goals separately.

In the first place, there is a large degree of subjectivity and a wide range of opinions as to exactly which—and to what degree—specific social and societal goals are to

[1] Letter to the Shareholders of Berkshire Hathaway Inc. dated February 25, 2012, p. 17

be preferred. While we all may agree that war is tragic, tobacco use can be harmful to human health, and contaminating the ground and water with toxic substances is inexcusable, there are less clear-cut instances (such as the humane testing of life-saving medications or the environmentally responsible production of life-enhancing energy sources) where the societal benefits may outweigh—or at least partially offset—the costs. In the end, many of these issues end up being in the eye of the beholder.

A further difficulty arises from the fact that many truly non-traditional and transformational products or processes are financed by high-risk venture capital or research and development efforts within large companies. In the case of the former (venture capital), the risk of capital loss may make these investments inappropriate for fiduciaries. In the case of the latter (large company R&D), the desirable "social" or "impact" projects are often dwarfed by the activities of the parent corporation. Thus these are not "pure play" investments in the areas of interest to the "socially responsible" investor.

Notwithstanding these difficulties, it is undeniable that the most successful investments are often in companies with operations and products which are sustainable over the very long-term, allowing the tremendous power of compounding to come into play. In this sense, irresponsibly managed or broadly harmful businesses will not remain successful for long and therefore are poor investments and should be avoided. On the other hand, well-run businesses, which over many years provide clear benefits to customers and to the communities in which they operate, can clearly fit within the demanding definition of "good investments" while remaining "socially responsible".

Over the years, a system of ranking business and corporate attributes has been developed based on the so-called ESG (Environmental, Social and Governance) categories. For our clients who desire their investments to be managed in an explicitly "socially responsible" way, we utilize the Vanguard Social Index mutual fund, which incorporates the ESG system.

## The ESG System

While there are a number of different methods and metrics to screen companies and businesses using ESG, we will focus on the Financial Times Stock Exchange ("FTSE") 4Good US Select Index as an example since this is the index used by the Vanguard Social Index fund for tracking purposes. This index uses the FTSE ESG Ratings Model which ranks companies using over 300 individual indicators across 14 different metrics within the Environmental, Social and Governance categories, as illustrated in the chart[2] below:


FTSE uses publically available data to apply their ESG screen, and resulting ratings, to the universe of companies. As described by FTSE, "The resulting ESG ratings fall under the oversight of an independent committee comprising experts from the investment community, companies, NGO's, unions and academia. The committee meets regularly to oversee ESG Rating reviews and methodology development[3]."

Once the universe of companies is screened using the 14 metrics in the aforementioned ESG model, an ESG Rating, from 0 (lowest) to 5 (highest), is applied to each individual company based upon their

2 "Index Overview", FTSE 4Good Index Series, FTSE Russell

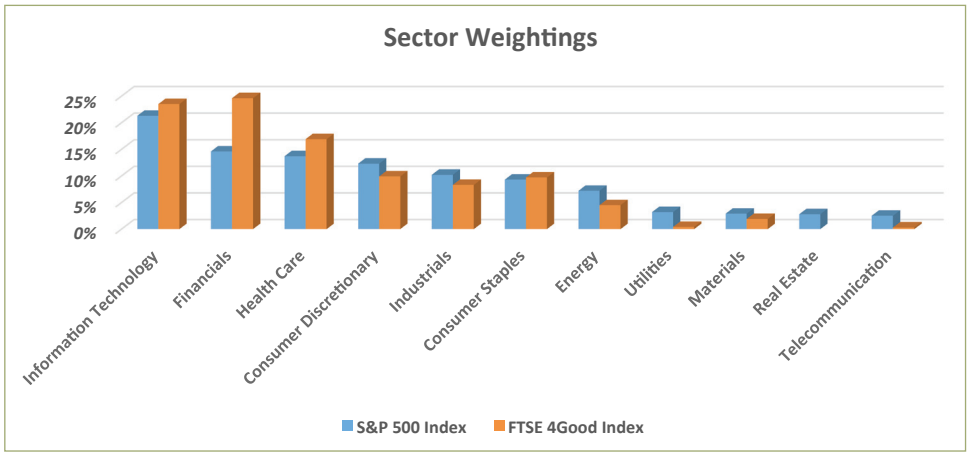
3 "Index Inclusion Rules for the FTSE4Good Index Series", V1.8, FTSE Russell

relative scoring within each category. FTSE uses this ESG Rating to ultimately determine inclusion or exclusion from the 4Good US Select Index, based upon the domicile of each respective company. That is, companies that are domiciled in a country categorized as a developed market have a higher minimum rating threshold (3.1 out of 5) to be considered for inclusion in the index versus a company domiciled in a developing (or emerging) market (2.0 out of 5). Similarly, for companies which are already included in the index, the minimum rating required to remain in the index is different according to the country of domicile (2.5 for companies domiciled in developed markets and 1.8 for companies domiciled in developing/emerging markets).

Similar to other ESG indices, FTSE incorporates some "hard exclusions" into its ratings methodology. For example, regardless of a company's ESG rating, all companies involved in the production or sale of tobacco, weapons systems, components for controversial weapons, or coal are excluded from the index. Furthermore, companies involved in the production of nuclear power generation or infant formula must meet a higher, or more stringent, threshold within the list of ratings indicators to be considered for inclusion into the index. In order to reduce turnover within the index constituents, a company failing to meet the minimum ratings threshold is given a 12-month grace period before being removed from the index.

## Performance of the FTSE 4Good US Select Index

Before comparing the performance of the FTSE 4Good US Select Index to the broad domestic equity market, as represented by the S&P 500, it is worth noting the differences in sector weightings across both indices. As we can see in the chart[4] below, the FTSE 4Good US Select Index carries some notable sector over-weights in information technology, health care, and financials, in particular:




The top ten holdings[5] in the FTSE 4Good US Select Index, which comprise 24% of the fund's total assets, are reflective of the index's sector over-weights:

| | | |
|---|---|---|
| 1 | Apple Inc. | |
| 2 | Microsoft Corp. | |
| 3 | Alphabet Inc. | |
| 4 | Johnson & Johnson | |
| 5 | JPMorgan Chase & Co. | |
| 6 | Wells Fargo & Co. | |
| 7 | Facebook Inc. | |
| 8 | Proctor & Gamble Co. | |
| 9 | Bank of America Corp. | |
| 10 | Pfizer Inc. | |
| Top 10 as % of Total Net Assets | | 24.0% |

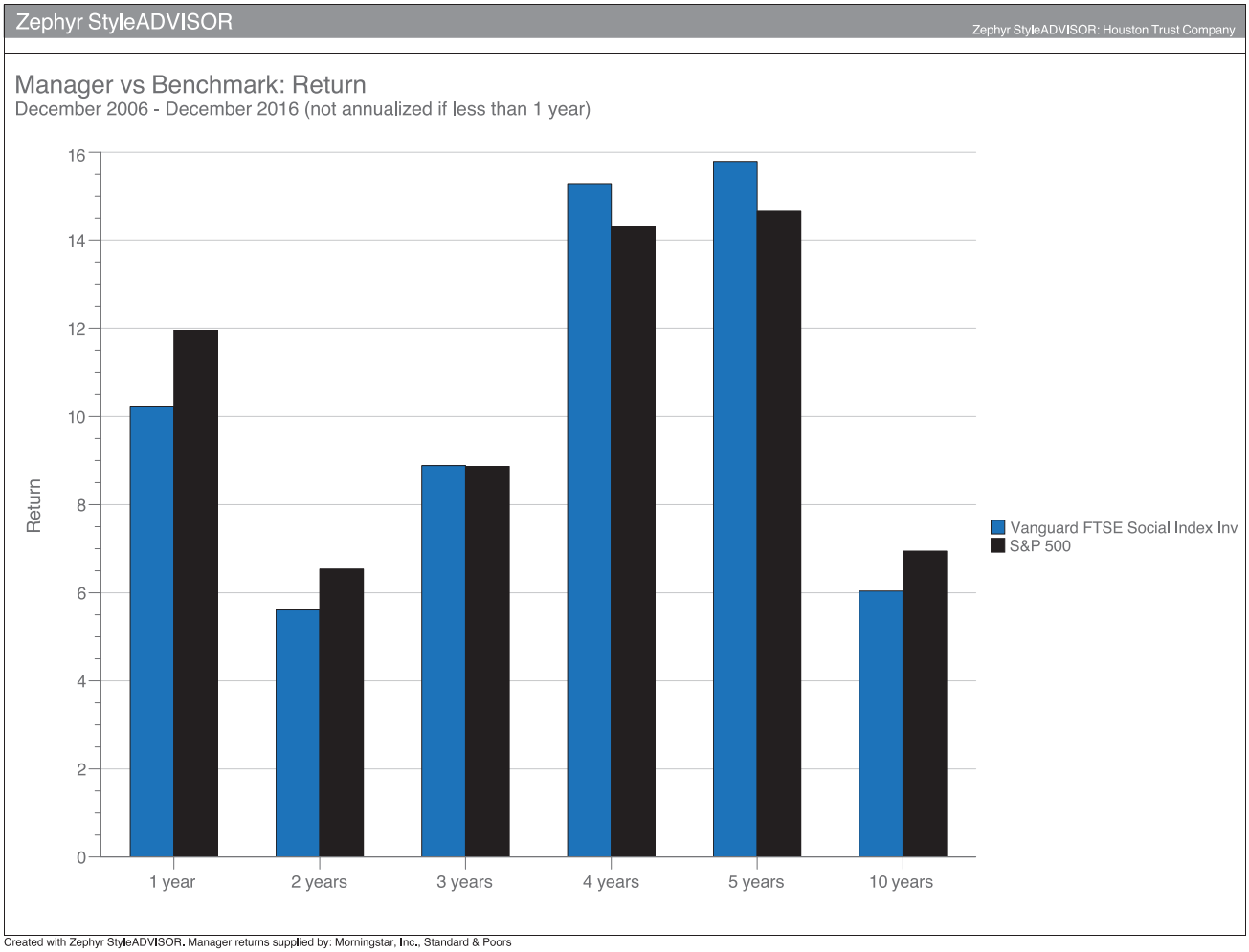
[4] Sector data provided by Vanguard as of 1/31/2017

[5] "Vanguard FTSE Social Index Fund", Fact Sheet, Vanguard, December 31, 2016

All of the stocks in the list of top holdings above are also represented in the S&P 500 index. Indeed, many of the fund's 444 holdings, which have a median market cap of $73.2 billion[6], are also contained within the S&P 500 index. From a valuation perspective, both indices look very similar in terms of earnings growth, Price/Earnings (P/E Ratio), Price/Book (P/B Ratio), and Return on Equity:

| Valuation Comparison[7] | | |
|---|---|---|
| | FTSE 4Good US Select Index | S&P 500 Index |
| Earnings Growth Rate | 8.20% | 8.30% |
| P/E Ratio | 22.7x | 22.7x |
| P/B Ratio | 2.9x | 3.0x |
| Return on Equity | 18.30% | 17.40% |

Given the similarities between the two indices, from both a valuation and individual constituent perspective, we can conclude that one of the primary drivers between the performance of the FTSE 4Good US Select Index relative to the broader US equity market can be attributed to the weighting differences in the underlying stocks, which in turn, drives the relative differences in sector weightings between the FTSE 4Good US Select Index and the S&P 500 index. As we can see in the chart below, the performance of the FTSE 4Good US Select Index (as represented by the Vanguard FTSE Social Index fund) relative to the S&P 500 are generally in-line with one another, looking back over the 3, 5, and 10-year periods ending 12/31/2016:




[6] "FTSE Social Index Fund Investor Shares", Vanguard.com

[7] Data provided from Vanguard.com as of 1/31/2017

While the relative performance between the Vanguard FTSE Social Index and the S&P 500 tends to fluctuate from year-to-year, depending on which sectors are most in favor at that particular time, the longer term 10-year annualized performance of +6.04% is within reach of the S&P 500's +6.95% annualized return. This 10-year historical return also includes the results of the most recent bear market in 2008, when the S&P 500 produced a -37.00% total return, compared to the Vanguard FTSE Social Index's -42.39% total return. Looking back over five years, the Vanguard FTSE Social Index produced an annualized +15.80% return relative to the S&P 500's +14.66%. This healthy outperformance during a period best characterized by a bull market cycle in equities is likely attributable primarily to the index's over-weights to information technology, financial, and health care stocks.

## Conclusion

As fiduciaries, we focus first and foremost on the preservation, and prudent investing, of our clients' assets. Inherent in this duty is the separation of political, religious and social views from the investment decision making process. However, for clients keenly interested in using their wealth to invest in companies which rank high on environmental, social and governance metrics, we have found the Vanguard Social Index fund to be attractive among the list of options in this space. Interestingly, from the analysis above, one doesn't "give up" much in the way of historical performance or risk (when measured both from a valuation perspective and from the drawdown experienced in 2008) by choosing to invest in a more socially responsible manner. Furthermore, this fund's 22 bps (0.22%) expense ratio is quite low on an absolute basis, and is it meaningfully lower than the 120 bps (1.20%) average expense ratio for all SRI (Socially Responsible Investing) funds tracked by Lipper Thomson Reuters[8]. Our open-architecture approach at Houston Trust Company provides our clients the ability, and flexibility, to invest with any number of managers, or funds, which best fit their goals, time horizon and investment objectives.

While there is much latitude in the way of defining, and measuring, which companies are considered to be "socially responsible", our duty as fiduciaries is to ensure that the managers, and funds, we utilize for the management of our clients' assets are prudent, sound investments which align within the goals and risk tolerances of our clients. In this regard, we have found the Vanguard Social Index fund to be a viable option for our clients who have expressed interest in having their assets managed in a socially responsible manner.

[8] Carlson, Debbie, "Socially Responsible Investing Comes of Age", Wealth Management Magazine, December 29, 2015