HOUSTON TRUST COMPANY

VIEWPOINTS

APRIL 2020, ISSUE 10

Socially Responsible Investing Revisited

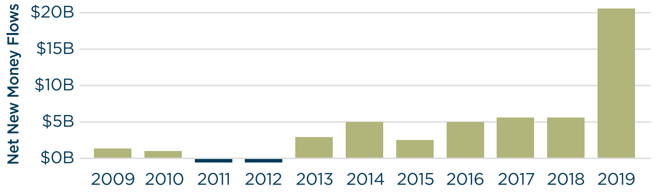
"Socially responsible investing" ("SRI") and "impact" or "sustainable" investing have emerged as important areas of the institutional investment landscape in recent years, as a new generation of investors and public pension plan and endowment trustees have debated the importance of investing capital to achieve socially desirable results. In March, 2017, we published a "Viewpoints" on this topic, and although our overall approach to this field has not changed, there have been additional issues which have arisen in this dynamic area of investing, so we thought it timely to revisit this topic.

Today, more than one quarter of total assets under management in the United States falls under the umbrella of sustainable investing. In Europe, market share is even greater at almost 50% of total assets invested in sustainable investing.

In 2019, sustainable funds grew by $20.6 billion, about four times more than in 2018. Previously, 2018 held the record for largest inflows into sustainable mutual funds and exchange-traded funds at $5.5 billion.[1]

ESG funds capture record flows in 2019

The investments raked in almost four times as much last year as the year prior



SOURCE: Morningstar

Such growth clearly indicates great interest in these new styles of investing, but it is also reflecting the creation of many different approaches and investment "products" which are being created and sold to address this need. This version of "Viewpoints" attempts to bring more clarity to this area, as well as to describe how Houston Trust approaches this mode of investing for our clients.

[1] Iacurci, Greg. "Money Moving into Environmental Funds Shatters Previous Record." CNBC, 14 Jan. 2020, www.cnbc.com/2020/01/14/esg-funds-see-record-inflows-in-2019.html.

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."[2]

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 not to 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 which – and to what degree – specific social and societal goals are to be preferred. While we all may agree that war is tragic, tobacco use can be harmful to human health, and deliberately 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 and food 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 are poor investments which are to be avoided, while 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".

Approaches to SRI

"SRI", "impact investing", and "sustainable investing" are broad umbrella terms which in application can be broken down into the following approaches:[3]

- *Positive Screens:* Actively seeking out companies with responsible environmental, social, and governance practices, broadly referred to as ESG (Environmental, Social, and Governance) screening.
- *Negative Screens:* Screening out companies with objectionable practices from an investment portfolio, such as those that have interests in gambling, alcohol, tobacco, or firearms.
- *Community investing:* Opening checking/savings accounts at a nonprofit credit union or community development financial institution (CDFI) that lends its deposits to disadvantaged communities.

[2] Letter to the Shareholders of Berkshire Hathaway Inc. dated February 25, 2012, p. 17
[3] "Impact Investing and Private Foundations: The Current Reality and Future Potential", Foundation Source, November 2019

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- *Program related investments:* Providing loans or loan guarantees to charitable organizations.
- *Mission-Related Investing:* Investing in equity or debt securities issued by profit-making ventures that address the foundation/endowment/pension plan's mission.

Our view at Houston Trust is that the first two approaches (negative and positive screens) allow the achievement of SRI objectives via public securities, and these investments possess the added benefits of liquidity and regulatory oversight of corporate operations and governance. The latter three approaches can require more direct involvement by the investing organization, thereby requiring a level of active management and oversight which may be beyond the capacities of the staff at more modestly sized foundations and endowments.

There are many strategies for incorporating sustainable investments into a portfolio. Globally, the largest sustainable investment strategy is to implement negative screens to exclude companies based on specific ESG criteria. About $20 trillion is managed with negative/exclusionary screening globally.[3] Following in popularity is ESG integration, where environmental, social and governance factors are incorporated into financial analysis. This leads to a larger allocation to ESG friendly stocks.

Over the years, a system of ranking business and corporate attributes has been developed based on the ESG categories. For our clients who desire their investments to be managed in an explicitly "socially responsible" way, we often 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[4] below:

FTSE uses publicly 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."[5]

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 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. Specifically, 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

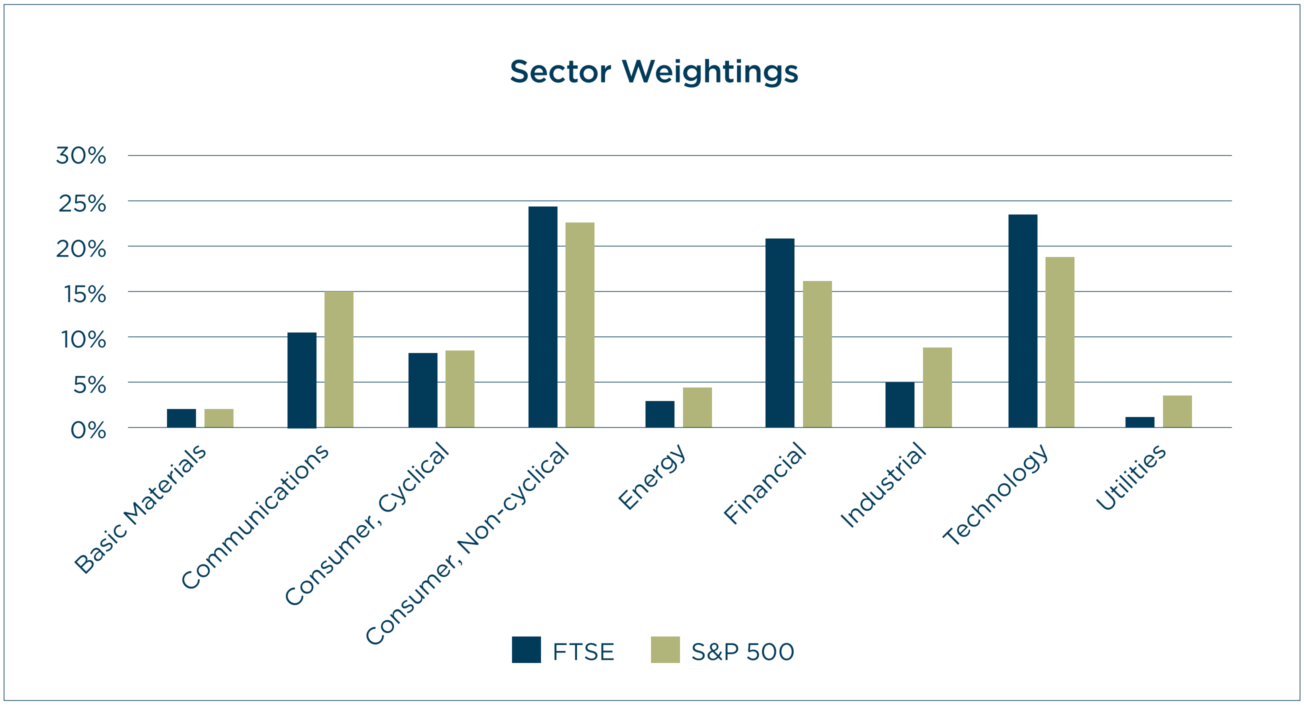
[4] Swedroe, Larry, "Does ESG/SRI Investing Reduce Stock Prices and Investment Returns?", Advisor Perspectives, December 18, 2019.
[5] "Index Inclusion Rules for the FTSE4Good Index Series", V1.8, FTSE Russell

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.

Analysis of 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[6] below, the FTSE 4Good US Select Index carries some notable sector over-weights in information technology, health care, and financials, in particular:



[6] Sector data provided by Vanguard as of 12/31/2019

The top ten holdings[7] in the FTSE 4Good US Select Index, which comprise 27.6% 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	Facebook Inc.
5	JPMorgan Chase & Co.
6	Johnson & Johnson
7	Visa Inc.
8	Proctor & Gamble Co.
9	Bank of America Corp.
10	UnitedHealth Group Inc.
Top 10 as % of Total Net Assets	27.6%

All of the stocks in the list of top holdings are also represented in the S&P 500 Index. Indeed, many of the fund's 482 holdings, which have a median market cap of $108.4 billion,[8] are also contained within the S&P 500 Index. From a valuation perspective, both indices look similar in terms of earnings growth, Price/Earnings (P/E Ratio), Price/Book (P/B Ratio) and Return on Equity:

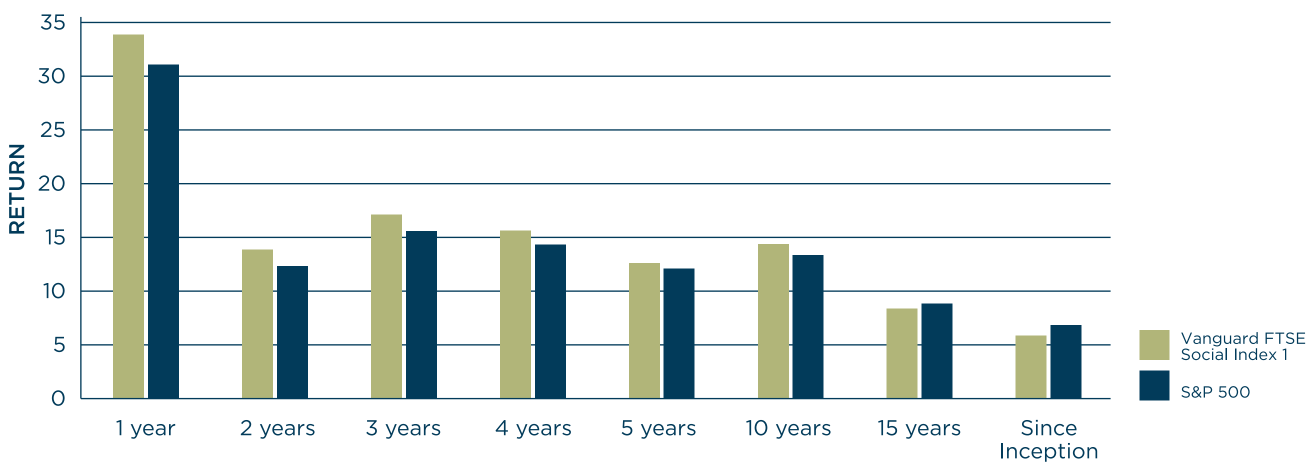
VALUATION COMPARISON

	FTSE Social Index Fund Institutional Shares (VFTNX)	S&P 500 Index
Earnings Growth Rate	13.30%	11.40%
P/E Ratio	21.9x	22.5x
P/B Ratio	3.6x	3.5x
Return on Equity	19.00%	18.20%

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 and 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 charts below, the relative performance of the FTSE 4Good US Select Index (as represented by the Vanguard FTSE Social Index fund) relative to the S&P 500 is generally in-line looking back over the 5 and 10-year periods ending 12/31/2019:

Manager vs. Benchmark Return

June 2000 - December 2019



[7] "Vanguard FTSE Social Index Fund", Fact Sheet, Vanguard, December 31, 2019

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

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 +14.38% has exceeded the S&P 500's +13.56% annualized return. Looking back over five years, the Vanguard FTSE Social Index produced an annualized +12.42% return relative to the S&P 500's +11.70%. This outperformance during a period best characterized by a bull market in equities is likely attributable primarily to the index's over-weight in information technology, financial, and health care stocks, which have been strong performers during this market cycle.

Sustainable/Green Bonds

The shift to sustainable investing is not limited to equity investing. Recently, the popularity of "green" and "sustainable" bonds has also been increasing. We have found there to be a wide range of definitions for green and sustainable bonds in the various papers we read in researching sustainable investing in the fixed income markets. For the purposes of this paper, green bonds are bonds issued exclusively for financing environmental goals, while sustainable bond issues finance a broader range of projects, supporting environmental, social, and governance initiatives.

Green bonds, which fund environmentally friendly projects, have grown in popularity very quickly. In the first half of 2019 green bond sales were up 44% from the same period in 2018.[9] Green bonds have very restrictive covenants, and issuers must ensure that the proceeds are to be used exclusively for clearly defined "green" purposes. For companies that want to evolve into a "greener" company, there are sustainability-linked bonds offering fewer restrictions.

With the increase in popularity of these types of debt issues, the fixed income market faces the challenge of determining and regulating who/what deserves the title of being a green or sustainable bond. One consideration for investors is that they must rely on the self-reporting of issuers who choose to follow green bond guidelines. An independent third-party evaluation of these issues would improve the transparency of these investments. Another challenge is that analysis of the accomplishments of green or sustainable objectives requires evaluating relative outcomes. For instance, one of the most tangible social goods is a public education. However, even within public school education there are many ways to define success. As with any type of new and evolving investment category, it will take some time and experience for industry standards and definitions to standardize.

[9] Freke, Tom. "Here's How 'Green Finance' Aims to Save the Planet." Bloomberg Markets, 5 September 2019

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 (if anything) in the way of historical return or add risk (when measured both from a valuation perspective and from the drawdown experienced in 2008) by choosing to invest in a socially responsible manner. Furthermore, this mutual fund's 12 bps (0.12%) expense ratio is quite low on an absolute basis, and it is meaningfully lower than the 120 bps (1.20%) average expense ratio for all SRI (Socially Responsible Investing) funds tracked by Lipper Thomson Reuters.[10] Our open-architecture approach at Houston Trust Company affords our clients the ability and flexibility to invest with any number of managers, or funds, in order to best achieve their 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 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.

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

ABOUT THE AUTHORS

David Rice Lummis
President and CEO

David Rice Lummis is a co-founder of Houston Trust Company. He currently serves as President and CEO, chairman of the Trust Committee, and the Company's Chief Investment Officer. For seven years prior to the formation of the Houston Trust Company, he oversaw stock and bond portfolios, operating businesses, real estate, litigation support, and estate planning for a large Houston family office. He was also involved for several years as a Representative in concluding the Howard Hughes estate administration. His investment management and capital markets experience includes four years as an investment banker in corporate finance and mergers and acquisitions with Lazard in New York.

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Matt Caire
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Matt Caire joined Houston Trust Company in 2014. As Senior Vice President of Investments, he is responsible for managing the firm's fixed income investments, performing equity manager due diligence, and constructing the asset allocations for client accounts. Matt previously was a Portfolio Manager with Patriot Wealth Management, where he managed approximately $500 million in fixed income investments. Prior to that, he was a Research Associate and Bond Trader with Linscomb & Williams.

Matt holds a Bachelor of Business Administration in Marketing, Cum Laude, from Texas State University and a Masters of Finance from the Tulane University Freeman School of Business. He is also a Chartered Financial Analyst (CFA®) charterholder, a CERTIFIED FINANCIAL PLANNER™ (CFP®) professional and a Chartered Market Technician (CMT). Matt serves as an Arbitrator for Financial Industry Regulatory Authority (FINRA), and he also teaches as an investments instructor for the CFP® Program at Rice University's Glasscock School of Continuing Studies.

Lauren Rogge Hall
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Lauren Rogge Hall joined Houston Trust Company in 2018. As Assistant Vice President of Investments, she is responsible for the investment performance reports and review of client accounts. Prior to her current role, Lauren was an intern at Houston Trust Company where she rotated through all of the company's departments.

Lauren graduated from Washington University in St. Louis with a Bachelor of Business Administration in Finance from the Olin Business School, and a minor in Computer Science. While earning her degree, she worked at numerous family offices and was part of the Olin Venture Consulting Program in Budapest.