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Sustainable Asset Management

By Brent Kessel, CFP

How two of the country's top financial planning and money management companies marry their clients' needs for personal financial contentment with a mission to make a positive impact on society.

Consider the following:

- The vast majority of mutual funds under-perform the simple strategy of buying a low-cost index fund year in and year out (Source: Morningstar)
- The average retail mutual fund investor grew $10,000 to only $21,422 between 1987 and 2005, earning 3.9% per year. A buy and hold investor using the S&P 500 index grew that same $10,000 into $94,555, earning 11.9% per year. (Source: Dalbar QAIB 2005)
- The total average cost of investing in the typical retail mutual fund is over 2.25% when you factor in all costs and expenses. (Source: Morningstar; fund prospectuses)

The Birth of Indexing

Since computing power became cheap and fast in the early 1990's, academics at the country's top business schools and institutional investors alike have known a dirty little secret: most individual investors don't make nearly as much money as they should for the risks they're bearing. This information began to be published by Vanguard, the giant mutual fund company who popularized the idea of indexing with its flagship S&P 500 Index Fund, founded in 1976 and which now has $107 billion in assets. Thus began the mainstream acceptance of a movement in asset management known as 'indexing' or 'passive management'.

As early as 1952, Harry Markowitz, who went on to win the Nobel Prize in Economics published studies proving that diversification reduces risk and importantly, that the kind of diversification that is most important is not security diversification-owning many different securities which basically move in concert with each other--but rather, portfolio diversification, in which each new security is evaluated in terms of how much it either reduces risk to or increases the return of the overall portfolio.

This revolutionary finding, along with further studies by other professors and Nobel Prize winners, confirmed that the best way to reduce risk and increase the growth of wealth was by investing in different classes of assets which didn't move in lock-step with each other. These classes include domestic small stocks, value or 'distressed' companies, and international stocks. Over the past twenty years, index funds (and the more recent exchange-traded funds) focusing on each of these classes have been developed by major financial services companies, and now manage trillions of dollars, primarily for large institutional investors and affluent individuals.

The Birth of SRI

In the mid 1980's, socially responsible investing (SRI) began to become a larger-scale movement in the investment markets, with major players like Cal-PERS and large university endowments deciding to withdraw their investments in companies which still did business in South Africa, at the time still governed by the Nationalist government and its abhorrent system of apartheid. Mutual funds began to spring up with a variety of social screens, including those which avoided South Africa, tobacco companies, and environmental polluters, to name but a few. While these mutual funds broke new ground by incorporating

their shareholders' values into the investment management process, they unfortunately exhibited the typical hallmarks which have hurt investors' performance for decades:

- Active management - employing a manager who feels that by picking 'better' companies and avoiding 'poor' companies, they would out-perform the benchmark indices, which they almost never can sustain for very long
- High costs
- Tax-inefficiency
- A predominant concentration in large, blue-chip companies

However, in 1991 Amy Domini combined these two powerful movements and created the first ever socially-screened index fund, the Domini Social Equity Fund. Then, nine years later in mid-2000, Vanguard teamed up with Calvert to offer the Vanguard Calvert Social Index Fund (now called the Vanguard FTSE Social Index Fund) with an expense ratio of only 0.25%. Since that time, almost no new low-cost index funds have arrived on the SRI scene, and the index funds which have been introduced have focused on large, blue-chip stocks. This presents a challenge to professional asset managers who wish to employ social screening and real diversification among different asset categories. At Abacus Wealth Partners and Kubera Portfolios, the two firms I co-founded, we have worked with the relatively limited tools available to allow clients to get the best of both worlds.

Most 'Sinners' are Big Business

Face it: it's quite a bit more difficult to convince teenagers to smoke, build a massive carbon-dioxide emitting plant, or wreak havoc on an ecosystem if you're a very small company. For this reason, most of the companies which SRI funds have had to exclude are large, well-known, blue-chip companies. Therefore, the first step our Investment Committee took many years ago was to find a large-stock SRI index fund which exhibited the positive characteristics that all of the impartial academic studies had shown us worked like low costs, good tax-efficiency, and an unshakable commitment to passive management, and substituted it in for the S&P 500 Index fund we had been using in that asset class. Over time we have used both the Domini and Vanguard funds referenced above for the U.S. large stock asset class. We found that by making this one substitution, we were able to bring the percentage of 'sinning' companies in our portfolios down from about 5% to less than one half of one percent (0.50%). However, for many of our clients, this wasn't quite good enough. Even knowing they had $5,000 of their $1,000,000 portfolio in companies which might be harming the environment or treating workers poorly was unacceptable.

So we went back to the drawing board. In 1996, an unknown money manager named James P. O'Shaughnessy published a book called What Works on Wall Street, which studied the factors which since 1950 have contributed the most to investment success. Like so many researchers before him, O'Shaughnessy discovered that a disciplined passive strategy was much better than stock-picking, that small stocks and value stocks tended to do better than blue-chip stocks over time, and that high costs were the enemy of the individual investor. But O'Shaughnessy's research went a bit further. Rather than buying an entire asset class-hundreds or thousands of stocks in a particular asset class, he wanted to find out what the performance looked like if one only bought 50 stocks per asset class. While on the surface this would seem to be much less diversification, O'Shaughnessy found that such a portfolio experienced less severe declines in a market downturn than the more broadly diversified indexes, and further, the performance was substantially better, often 5% - 9% better per year than the well-known index.

A few years ago, we asked O'Shaughnessy's team to apply social screening to these concentrated portfolios, which they did. This allowed us, for the first time, to offer our clients who wanted 100% social screening a domestic stock portfolio that was indexed, included important small and value stock assets classes, and exhibited great performance characteristics.

Recently, we have been working with Dimensional Fund Advisors, an $80 billion institutional money manager headquartered in Santa Monica, California, to allow our ultra-high net worth clients (those with more than $15 million in investments) to have 100% socially-screened portfolios which are diversified

across the entire world as well as the various sizes and styles of stocks. But our Investment Committee isn't finished yet. As we speak, we are researching new ways to combine the best of diversified passive indexing with SRI for more investors, regardless of the amount of their assets.

What's the Point of Making All this Money Anyway?

While investing is a very important component of experiencing financial contentment, if it's all kept for the benefit of one person or family, it tends not to make very much difference to one's sense of happiness. We believe that unless people are using their financial resources to make a positive impact on society, their fulfillment will be quite limited. Therefore, in addition to donating a substantial percentage of our profits to charity each year, we help our financial planning clients identify and employ the strategies that they feel will make the difference in the world that touches them the most.

The first way we do this is with philanthropy. When a new client comes to Abacus or Kubera, it is often during a time of life transition for them. They've just gone through a divorce, or a family member has died, or they've retired or sold a company. There's often an identity shift occurring, and part of that shift is that something which used to bring fulfillment-a spouse, a parent, a career-is no longer in their life. In its place is usually a sum of money the likes of which our client has never had the responsibility of managing. This can be very overwhelming.

As we go through the process of identifying what's most important to our client--what brings them joy, what they're most afraid of, when they've been most touched in their lives, and how they'd like to spend their precious time--we take note of the philanthropic wishes that arise in our conversations. We then look at their financial resources to see how we can most efficiently fund those wishes. Often, by using highly appreciated assets or real estate, we are able to help the client provide much more benefit to their cause at a lower after-tax cost to themselves.

The second way we do this is with alternative investments. In the last several years, a few select funds have emerged which are focusing on providing capital to sustainable private businesses (as opposed to publicly-traded companies) in 'clean' industries. Some of these companies pursue clean energy alternatives while others focus on sustainable jobs. Because these are non-publicly traded private equity funds, they are only suitable for accredited investors-those with a net worth of greater than $1,000,000, and bear a high degree of risk. However, the financial and social returns are usually much higher than one can get in typical investment vehicles.

Another class of alternative investments is microfinance-providing very small loans (typically $100-500) to micro-entrepreneurs in Third World countries. Surprisingly, the repayment rates on these loans is typically 95% or higher, and in major economic crises, these micro-loans tend to hold up better than large commercial bank loans made to big companies. Typically one gives up some or all financial return (there are micro-funds paying anywhere from 0% - 4% in returns) in exchange for the knowledge that you are creating an exceptional social return. A $10,000 investment in a micro-finance fund will finance roughly 50 businesses which provide the livelihood for 250 impoverished people. And even better, when the loan is paid back, you can recycle your capital to another 250 people.

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