TFC FINANCIAL
The Financial Counselors

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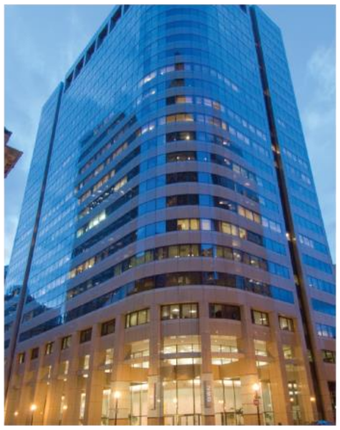
OUR VIEW



*In recent years, the term **sustainable investing** has been frequently used to describe responsible investing activities.*

Responsible Investing Background

Responsible investing is any investment strategy which seeks to consider both financial return and social good. There are a wide variety of terms used, sometimes interchangeably, by proponents for responsible investing. Early practitioners of responsible investing commonly used the term *socially responsible investing* (SRI) to describe their approach. In recent years, the term *sustainable investing* has been frequently used to describe responsible investing activities. Sustainability is a central aspect to the responsible investing movement, centered on the desire to avoid depleting natural resources while doing no harm to the environment.

Impact investing is a distinct approach to responsible investing, through investing in projects or companies with the intent to effect mission-related social or environmental change. *Environmental, social and governance* factors (ESG) are commonly used factors in measuring the sustainability and ethical impact of an investment in a company or business, and some investment managers refer to their product offerings as *ESG strategies*.

Many responsible investing practitioners are *activist investors*, engaging in shareholder advocacy intended to influence corporate behavior through shareholder resolutions, proxy voting and engagement with company management.

Morningstar has a broadly inclusive definition for responsible investing strategies, placing a wide range of investment products in their socially screened category. According to Morningstar, assets in socially screened portfolios now exceed $6 trillion, up from $639 billion in 1995. Socially screened or influenced mutual funds increased at a steady rate over the past decade, in response to growing demand from individual investors. A recent Morgan Stanley survey of individual investors highlights the coming demand for responsible investments, with 71% of respondents (and 84% of millennial investors) expressing interest in sustainable investing.

Table 1: Largest Socially Screened Mutual Funds

	Name	Size [$]
1	Parnassus Core Equity	11.7 B
2	Calvert Equity	2.8 B
3	TIAA-CREF Social Choice Equity	2.8 B
4	Neuberger Berman Socially Responsive	2.3 B
5	Invesco Summit	1.9 B
6	Vanguard FTSE Social Index	1.8 B
7	American Century NT Large Company Value	1.5 B
8	American Century NT Equity Growth	1.4 B
9	Parnassus Endeavor Fund	1.2 B
10	American Century NT Growth	1.1 B

Source: Morningstar Direct as of 6/30/2015.

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Evolution of Responsible Investing

Responsible investing is thought to have started with the Quakers in the mid-1700s. The Quakers prohibited their members from participating in the slave trade, marking the start to what later became known as the socially responsible investing (SRI) movement. John Wesley, one of the founders of Methodism, was cited for his leadership through his opposition to the slave trade and call to his followers to shun profiting at the expense of their neighbors. SRI was most commonly a faith-based phenomenon for many years, applied through investment mandates that avoided "sin" stocks such as alcohol, tobacco, gambling, and pornography.

The movement toward integrating ESG characteristics into traditional investment practices has been embraced by investors who believe that companies with stronger ESG attributes will be more innovative, will attract and retain customers and employees, and will have a competitive advantage over companies with weak ESG characteristics.

Dissatisfaction about the war in Vietnam led to a broadening of interest from investors wanting to avoid investing in companies fueling the war effort. In subsequent years, the protest movement against the apartheid regime in South Africa was a seminal event in the evolution of SRI, as college students called upon corporate pension plans, university endowments, and public pension plans to divest from South Africa. Environmental awareness also became a focal point of the SRI movement, driven by high profile environmental disasters such as the partial meltdown of the nuclear reactor at Three Mile Island and toxic waste in the Love Canal.

The exclusionary approach to SRI – avoidance of alcohol, tobacco, weapons manufacturers, repressive regimes, and major polluters – was the primary focus for the first wave of investors embracing an investment approach that integrated personal values into investment decision-making.

Socially conscious investors in recent years have strived to make a broader impact by going beyond purely exclusionary screening. Investors increasingly use ESG factors to uncover hidden risks and identify potential sources of added value. The movement toward integrating ESG characteristics into traditional investment practices has been embraced by investors that believe that companies with stronger ESG attributes will be more innovative, will attract and retain customers and employees, and will have a competitive advantage over companies with weak ESG characteristics. Socially conscious investors often talk about "*doing well by doing good,*" meaning that they believe that investments that integrate ESG considerations will provide strong investment returns while making the world a better place.

Responsible Investing in Mutual Funds and ETFs

Investors who are interested in responsible investing have a variety of choices. Some investment products focus only on excluding "bad" companies, while others utilize both an inclusionary and exclusionary approach to screening. Investment styles also vary widely. Some *index-oriented* responsible investment products are managed to target returns in line with broad-based indexes such as the S&P 500, others are managed with the objective of matching returns of indexes created using ESG factors, such as the MSCI KLD 400 Social Index. *Actively managed* responsible investment products may be less tied to an index, utilizing an active approach to both social screening and investment selection. Responsible investment products can be placed into three general categories:

- Socially-responsible investing (SRI): A portfolio construction process that attempts to avoid investments in certain stocks or industries through *exclusionary criteria tied to defined ethical guidelines*. There are a wide variety of investment products that use negative screening techniques, ranging from approaches that restrict a handful of stocks to those that exclude broad areas of the market.

  The DFA U.S. Social Choice Equity Core 2 Fund is an example of a fund that relies on a purely exclusionary approach, with exclusions that include companies with material involvement with the Sudan, alcohol, tobacco, gambling, pornography, and weapons. American Century also relies on an exclusionary approach, though their three funds listed in the top 10 list above are often considered "SRI-lite" as their only social screen is to exclude tobacco stocks.

- Environmental, social and governance (ESG) investing: Thought of as a best-in-class approach, ESG investors assign a score or rating to each company in the investment universe based on ESG considerations. The score or rating is used to identify which companies to include as well as which to exclude from the portfolio. Many ESG investors may combine the ESG approach with exclusionary screens that further determine which companies or industries are excluded from the portfolio.

  The ESG approach may allow for companies that are "better" corporate citizens to be included in a portfolio, even if their sector has unfavorable ESG attributes as a whole.

  TIAA-CREF started offering retirement services to teachers nearly 100 years ago. TIAA-CREF is now a full services financial firm, having expanded beyond its original base of teachers to offer investment products to retail investors and institutions. The TIAA-CREF Social Choice Fund is one of the larger ESG mutual funds. TIAA-CREF uses ESG screening services offered by MSCI, supplying high level criteria for MSCI to use in creating a universe of acceptable investments from an SRI perspective. From that broad-based potential universe, TIAA-CREF uses a quantitative process to attempt to track the risk characteristics of the standard Russell 3000 Index, holding about 800 individual stocks. The fund may differ meaningfully from the index at the stock level, with major companies such as Apple and Exxon Mobil excluded for ESG reasons.

  Calvert is one of the firms with the longest history of managing responsible investing portfolios. Calvert's approach is founded upon a belief that integrating financial and ESG analysis leads to better investment decision-making. They emphasize the early warning signs that ESG analysis can provide, that a brand may be at risk of being tarnished or that margins may be compromised due to factors not identified by standard financial metrics. Calvert's approach for one of its flagship mutual funds, the Calvert Equity Portfolio, differs from TIAA-CREF in the way that ESG analysis is fully integrated into the stock selection process rather than used as an up-front screening device. The Calvert Equity Portfolio is managed with the help of Calvert's sub-advisor, Atlanta Capital, who constructs a preliminary portfolio based on fundamental analysis, and then refines that portfolio after applying Calvert's ESG analysis to each position.

The lack of uniform standards is a commonly discussed constraint faced by ESG practitioners, as some of the data used relies upon voluntary corporate disclosures or imprecise metrics. A non-profit group, the Sustainability Accounting Standards Board, is working on establishing uniform standards to help provide better and more consistent disclosure data to assist in the ESG process.

- Thematic Approach: The thematic approach to responsible investing is aligned to a specific issue rather than a broad-based socially-driven objective. A thematic investment product such as the iShares MSCI ACWI Low Carbon ETF (CRBN) invests in companies that have low carbon output and reserves, but includes alcohol, tobacco and mining companies typically shunned by SRI and ESG proponents. The Pax Ellevate Global Women's Index Fund is another thematic product, offering a mutual fund focused on female empowerment, but not necessarily aligning with other common responsible investing issues.

  The Green Century Balanced Fund combines thematic and ESG considerations, focusing primarily on environmental issues, while also avoiding nuclear energy, tobacco, factory farming, and genetically modified organisms.

Investment theory suggests that any investment constraints potentially limit returns. However, proponents for responsible investing argue that either the constraints have limited impact or that the impact is balanced between positive and negative contributions that offset.

Worth noting is that the use of ESG characteristics is becoming more common among mainstream investment management firms, as firms such as MFS integrate some form of ESG research into their fundamental analysis of companies and industries. This work isn't social screening, per se, as the portfolio managers may invest in companies with poor ESG metrics, but is an endorsement of ESG criteria as an input to the decision-making process.

Separately Managed Accounts

A limitation to any responsible investing mutual fund or ETF is that the product sponsor determines what ESG considerations are used to create the portfolio, and the inclusionary or exclusionary considerations of the product sponsor may or may not be aligned with that of the investing client. Consequently, some clients may not find an investment product that fully meets their preferences. Separately managed accounts (SMA) may be an alternative, offering customization of the investment universe, inclusions and exclusions. Minimum account sizes and management fees vary for SMAs, and clients may have to be more involved in account set-up than would be the case for a mutual fund or ETF purchase. The SMA structure is much more practical to implement for large-cap U.S. stocks, conceivably limiting diversification unless the client supplements the SMA with mutual funds or ETFs for asset classes such as small cap, international and emerging markets.

Performance of Responsible Investing Mutual Funds

Many researchers have reviewed the performance of responsible investing mutual funds to evaluate whether there are performance trade-offs associated with values-driven investments. Results have been mixed. Investment theory suggests that any investment constraints potentially limit returns, however, proponents for responsible investing argue that either the constraints have limited impact or that the impact is balanced between positive and negative contributions that offset.

A 2015 study by Advisor Partners evaluated the performance, risk and cost of actively managed socially screened mutual funds, following a path covered by prior researchers attempting to determine whether actively managed socially screened mutual funds provide materially different performance results than actively managed mutual funds that don't incorporate social screening methods.

Some observers might argue that prior research studies attempted to answer the wrong question. Proponents of index investing say that instead of asking, "Do actively managed socially screened funds perform as well as conventional actively managed funds?", that the right question to answer is "Do actively managed funds perform as well as a passive index?" The Advisor Partners research examined both dimensions of performance analysis.

Actively managed, socially screened mutual funds performed well in comparison to actively managed conventional mutual funds, during the ten-year period shown in Tables 2 and 3 below. Table 2 shows performance for the large cap blend category, the blend style defined as mutual funds where neither growth nor value characteristics predominate. Table 3 shows performance for the large cap growth category. A limited number of value funds utilize social screening techniques, not enough for substantive analysis.

Table 2: Large Cap Blend Active SRI Fund Performance Characteristics
Ten Years 2005-2014

	Return	Standard Deviation*
Best SRI Performer	10.2%	13.1%
SRI Group Average	7.9%	15.1%
Non-SRI Group Average	7.1%	15.3%
Worst SRI Performer	6.6%	15.7%
Source: Advisor Partners, Morningstar Direct.		

*Standard deviation is a measure of volatility

Table 3: Large Cap Growth Active SRI Fund Performance Characteristics Ten Years 2005-2014		
	Return	**Standard Deviation***
Best SRI Performer	9.9%	19.1%
Non-SRI Group Average	7.7%	16.2%
SRI Group Average	7.3%	15.5%
Worst SRI Performer	6.0%	15.3%
Source: Advisor Partners, Morningstar Direct.		

*Standard deviation is a measure of volatility

Actively managed socially screened funds have had the same difficulty in beating passive commercial benchmarks that their non-responsible investing peers have had.

Comparisons to a passive index were less favorable for actively managed, socially screened mutual funds. Actively managed, socially screened funds lagged the index over most periods reviewed, often at a higher risk than the broader index. Socially screened large cap blend funds lagged the S&P 500 Index for the five years ending December 31, 2014, returning 16.66% per year, while the index returned 17.22%. The five years ending December 31, 2000, which included the "technology bubble" and aftermath, were significantly worse, with socially screened mutual funds returning 15.93% per year while the index returned 21.34%.

However, socially screened large cap blend performance for the ten years ending December 31, 2014 was slightly better than that of the S&P 500 Index, though with a higher standard deviation (Table 4). Socially screened large cap growth performance didn't fare as well over than period (Table 5).

Table 4: Large Cap Blend Active SRI Fund Performance Characteristics Versus Index Ten Years 2005-2014		
	Return	**Standard Deviation***
SRI Group Average	**7.9%**	**15.1%**
S&P 500 Index	**7.7%**	**14.7%**
Source: Advisor Partners, Morningstar Direct.		

*Standard deviation is a measure of volatility

Table 5: Large Cap Growth Active SRI Fund Performance Characteristics Versus Index Ten Years 2005-2014		
	Return	**Standard Deviation**
SRI Group Average	7.3%	15.5%
S&P 500 Growth Index	8.6%	14.1%
Source: Advisor Partners, Morningstar Direct.		

*Standard deviation is a measure of volatility

Expenses can be "silent killers," eroding returns for often unsuspecting investors. Investing in actively managed, socially screened mutual funds can be an expensive proposition. Expense ratios for such funds average approximately 1.2%, and range from a low of 0.84% to a high of 1.5%. Average expenses for socially screened mutual funds are slightly lower than that of actively managed funds in the same category, but are considerably higher than that of index funds, even index funds with a socially screened component.

Actively managed, socially screened funds have had the same difficulty in beating passive commercial benchmarks that their non-responsible investing peers have had. Actively managed responsible investing funds lagged the index over most periods reviewed, often at a higher risk than the broader index. The high cost of many strategies may have some impact, serving to erode returns and reinforcing the frequently heard refrain that low cost, low turnover, disciplined strategies "win" in many asset classes.

The responsible investing mutual fund universe included approximately 70 funds in mid-2015, and only 23 funds within the universe had a performance history of greater than ten years. The small sample size of responsible investing funds, particularly in context of a universe of more than 3,000 mutual funds, may constrain the conclusiveness of the performance research findings. An increase in the number of responsible investing funds and rapidly evolving approaches to responsible investing increases the possibility that coming decades will be different than the prior decades.

Closing Thoughts

Responsible investing isn't for everyone. The more constraints placed on an investment portfolio, the higher the risk that the portfolio will fall short of the portfolio's financial objectives. We think there is merit to the thesis that ESG factors can contribute to investment success, but believe that traditional investment firms that integrate ESG into an already robust investment process will have more long-term success than many of the responsible investing firms covered by the performance research cited above. However, we offer some high level thoughts as a starting point for investors who have both social and financial objectives and look forward to having a deeper conversation about your needs and objectives:

- Define what you want to accomplish: Defining the investment objective, social considerations and time horizon are a critical step in the process. Determining your core values, and how to align those values with your investment portfolio requires some introspection and consultation with your TFC advisor.
- Decide whether you want absolute or directional alignment with your values: There are a wide variety of responsible investing mutual funds and ETFs. Mutual funds and ETFs are "easy," in that it's a simple process to buy and sell them. However, it's unlikely that you'll find a mutual fund or ETF that is 100% aligned with your personal values. If directional alignment is enough, a mutual fund or ETF may satisfy your needs. If absolute alignment is important, a separately managed account may be more suitable. However, absolute alignment comes with a cost, potentially in higher fees, complexity, or personal involvement in the design process.

- Understand the investment implications: There may be financial trade-offs associated with a responsible investing strategy. Work with your TFC advisor to understand the investment risks associated with different values-driven investment strategies, so that you're fully informed about the environments in which the strategy will thrive or struggle.

Responsible investing is an emerging area of focus for TFC. We'll continue to share our thoughts with you as we research related topics, and develop a spectrum of investment alternatives for those who wish to pursue responsible investing options.

As always, we welcome your comments and questions.

Sincerely,

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