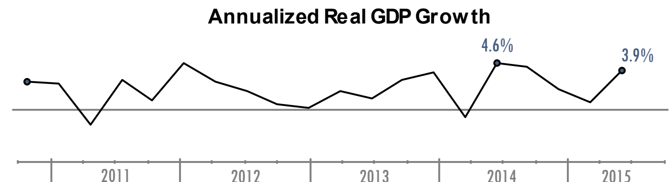
Bellwether CONSULTING

Your Quarterly Update on the Financial Markets
September 30, 2015

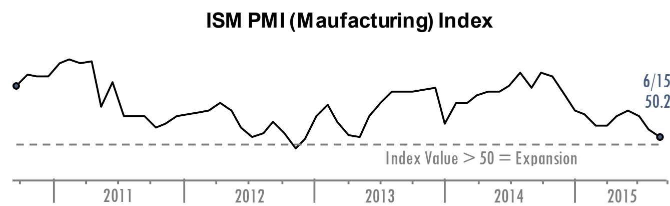
MARKET Recap

The US Economy: "Heady Views from the Top"

After a brief weather-related respite, US economic growth accelerated back to its previous pace. Nearly every sector contributed to increased growth in Q2; rising imports was the only notable exception.



Incremental data for the third quarter were mixed. No single number leapt off the page, but several key indicators were modestly softer, suggesting the possibility of a cyclical peak. The Institute for Supply Management's PMI index, which tracks several indicators of business activity for manufacturers, declined to 50.2 in September (an index value of 50 or higher indicates expanding business conditions). Among other components, new orders for durable goods decreased in August, as did the backlog of orders. Employment increased by 142,000 in September, compared to an average of 198,000 per month in 2015 and 260,000 per month in 2014. For the quarter unemployment fell from 5.3% to 5.1%.

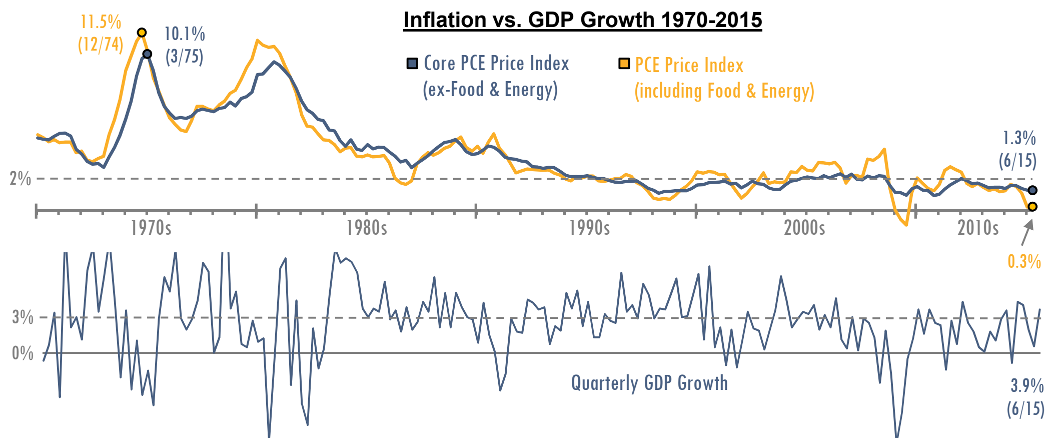


The Federal Reserve left rates unchanged at their much-watched meeting in September, and frankly sent mixed signals about the pace of future rate hikes. In her semiannual Monetary Policy Report to Congress in July, Chairman Yellen remarked that economic conditions likely would make it appropriate at some point this year to raise the federal funds rate target. 15 of the 17 policymakers which contribute to the Fed's Summary of Economic Projections saw it that way at the time. In contrast, Ms. Yellen delivered a lecture on September 24th at the University of Massachusetts, Amherst focused on the importance of inflation in setting monetary policy.

In particular, her arguments on the danger of persistently low inflation stood out. Nominal interest rates are more-or-less bound to a minimum of 0%, and the inflation rate sets a negative lower bound on real interest rates. Her concern is that, if inflation is too low, the Fed has less ability to provide stimulus in response to an economic downturn by lowering real interest rates. The Federal Reserve targets 2% inflation measured by the Personal Consumption Expenditures Price Index, a statistic which follows the change in prices of goods and services consumed in the US. Following the stagflation of the 1970's and recovery of the 1980's, inflation as measured by this method has hovered below the Fed's target, particularly in the period following the credit crisis. Two factors have worked against the Fed's efforts to raise inflation – sharply falling prices for oil and other commodities, and strengthening of the US dollar. While policymakers generally view commodity and currency price effects as "transitory," the magnitude and persistency of the trends are too great to dismiss.

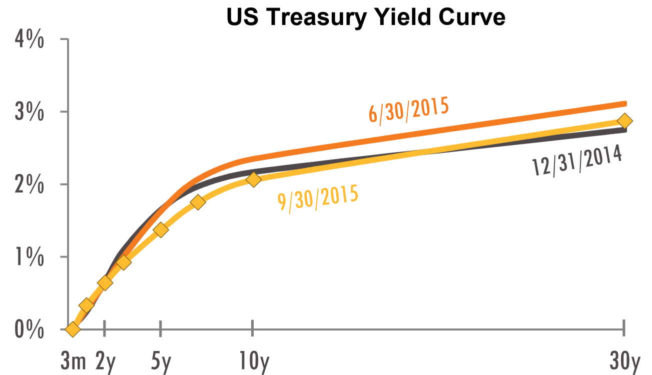
If inflation of consumer prices is currently the primary focus for the Fed, it seems unlikely they will raise rates until these transitory forces abate. That could happen very quickly, but we don't see the catalyst at this time. Unfortunately, the side-effects of current policy continue to accrue, including inflation of asset prices. That equity prices are inflated is the worst-kept secret in the market, and any sign of underlying weakness triggers fear-induced selling – as was demonstrated in the third quarter.

Woe to investors should the emergence of inflation and Fed tightening coincide with the top of a business cycle!



The US Bond Market

In Q3, the yield curve regressed back near where it started 2015. The 2yr ended the third quarter at a yield of 0.64% and the 10yr at 2.06%. Compare this to the end of 2014, when yields on 2's and 10's were at 0.67% and 2.17%. While the tail end of the curve has weakened slightly, with the long bond rising 12 bps over the past nine months, US Treasuries have reaped positive total returns across the board YTD. The FOMC's decision to keep rates unchanged following their September meeting erased a 2-day spike in yields leading up to the announcement and caused the 6-month key rate to retreat back nearly 20 bps to its long-term range around 7-15 bps.



Credit spreads widened substantially this quarter as the economic outlook deteriorated globally and the Fed rate hike loomed. US AA corporate spreads were out 13 bps while high yield spreads were 162 bps wider, the largest move since a dramatic 3 point blowout in 3Q2011 and. In the two weeks leading up to the end of the quarter, high yield spreads moved out more than a full point, while BBB's widened 47 bps and AA's just 3 bps (BAML Spread Indexes). High yield issuance started soft in July before ramping up moderately through August and September to reach a modest $42.8 billion for the quarter. In contrast, investment-grade issuance was robust in July and, despite faltering in August, finished the quarter up 13% YTD versus the first nine months in 2014. High yield issuance YTD is down 9% versus the same period one year ago.

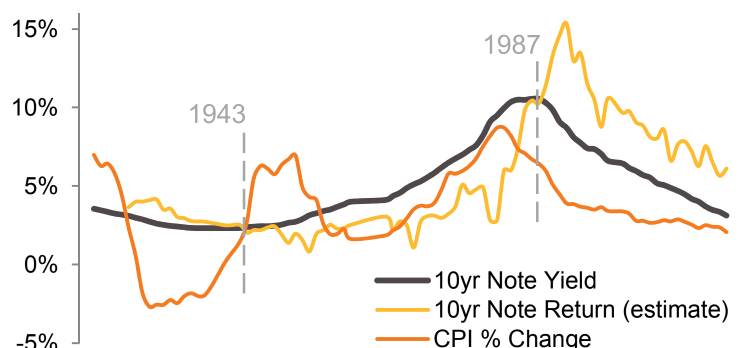
US Bond Index Total Returns

Barcap Indices	3Q15
Aggregate	1.23%
Interm. Gov't	1.21%
Long Gov't	4.97%
TIPS	-1.15%
Municipal	1.65%
Interm. Credit	0.54%
Long Credit	0.52%
High Yield	-4.86%
MBS	1.30%

Revisiting a topic from our prior US Bond Market Recap, Puerto Rico has since suspended payments on its public debt. The current administration has estimated a $13 billion shortfall in funds to repay principal and interest due on outstanding loans within the next 5 years. This is after accounting for tax increases and spending cuts amounting to over $14 billion over the same period.

Favorable tax treatment of Puerto Rico bonds, which are exempt from local, state, and federal taxes everywhere in the US, had helped the territory amass more debt than any state other than California and New York, despite GDP and population both below the median state. According to Morningstar, 20% of bond funds (mostly municipal and high yield) hold debt issued by Puerto Rico; yet, this amounts to only $11.3 billion of the $72 billion outstanding. Hedge funds have purchased roughly $15 billion (typically at a large discount), while Puerto Rico's residents own around $30 billion (typically bought at face value). The remainder is largely held directly by mainland American investors. The promised payments on PR bonds represent a critical source of income for many local residents. The Puerto Rican government plans to meet with investors by mid-October to begin negotiating a likely restructuring of debt.

It has been roughly 40 years since we have seen rising rates in the US. As we head toward a possible inflection point, we have only a single historical reference upon which to rely – one that is likely irreparably outdated. Indeed, rates move in a bewilderingly slow cycle. The most recent (to stretch the word) peaks were seen in the 1980s and circa-1910. Troughs appear to have occurred in 2012, circa-1932, and the late 1880s. What can we learn from the most recent cycle of rising rates? As the simulated performance from investing in the 10-year Treasury note show, nominal returns tended to remain in positive territory despite the challenging environment. Perhaps, the more troubling effect was the negative real returns seen during sporadic spikes in inflation during the mid-1930s and 1940s. Inflation is notoriously unpredictable, but short and long-term expectations are currently low. The 5-Year, 5-Year Forward Inflation Expectation Rate has fallen to a 5-year low at 1.75%, down from a high near 3% in 2013. In our previous recap we urged investors to consider, in the short-term, the pace of rate hikes over their initial timing. As we look to US bonds in the long-term, we emphasize proper respect for inflation.

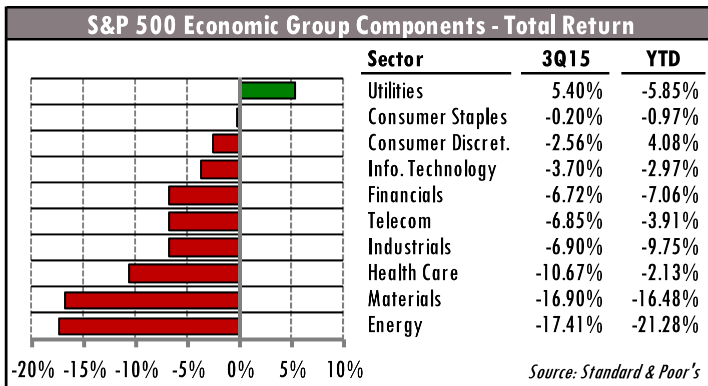


The US Stock Market

It was a tumultuous third quarter for US equities, which were hurt by concerns of economic growth globally. An August sell-off of Chinese stocks and government intervention in an attempt to cushion falling prices drove global speculation that the world's second-largest economy was much weaker than expected. This subsequently drove losses across global markets, including the US where many companies derive a significant portion of revenues from China and other emerging nations. Following losses on anxiety around China, a decision to hold the federal funds rate in place by the Federal Reserve led to additional worry over the strength of the US economy. Up until this point, investors had largely welcomed decisions to not raise short-term rates, marking a noteworthy change in perspective.

Stock Indices - Total Returns

Large-cap Stocks	3Q15	YTD	Mid-cap Stocks	3Q15	YTD
S&P 500	-6.44%	-5.29%	S&P Midcap 400	-8.50%	-4.66%
Russell 1000	-6.83%	-5.24%	Russell Midcap	-8.01%	-5.84%
Growth	-5.29%	-1.54%	Growth	-7.99%	-4.15%
Value	-8.39%	-8.96%	Value	-8.04%	-7.66%
Broad Markets			**Small-cap Stocks**		
Russell 3000	-7.25%	-5.45%	S&P Smallcap 600	-9.27%	-5.49%
Growth	-5.93%	-1.86%	Russell 2000	-11.92%	-7.73%
Value	-8.59%	-9.05%	Growth	-13.06%	-5.47%
			Value	-10.73%	-10.06%



S&P 500 Economic Group Components - Total Return

Sector	3Q15	YTD
Utilities	5.40%	-5.85%
Consumer Staples	-0.20%	-0.97%
Consumer Discret.	-2.56%	4.08%
Info. Technology	-3.70%	-2.97%
Financials	-6.72%	-7.06%
Telecom	-6.85%	-3.91%
Industrials	-6.90%	-9.75%
Health Care	-10.67%	-2.13%
Materials	-16.90%	-16.48%
Energy	-17.41%	-21.28%

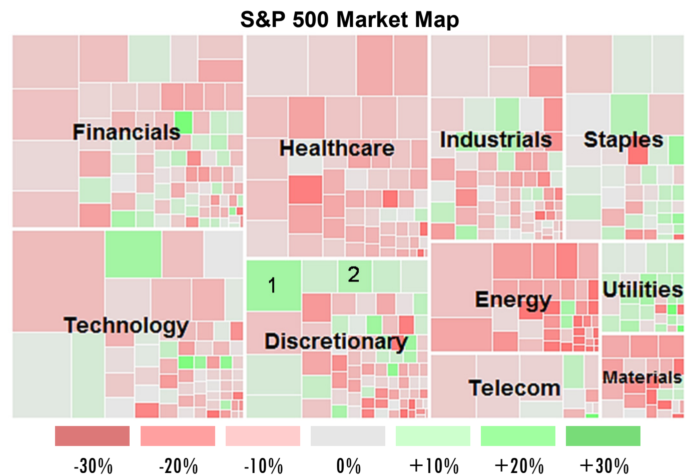
Source: Standard & Poor's

Over the three months, large-cap stocks outpaced their mid- and small-cap peers. Growth-oriented companies significantly outperformed value stocks within the large segment of the market, however value outperformed growth among small-caps. Year-to-date, investors have struggled to find high-quality cheap stocks amid heightened valuations, leading them to companies with greater growth potential. Additionally, dividend-paying stocks experienced slight outperformance during the quarter as investors favored their reduced risk profile and yield.

At the sector level, performance dispersion (degree of variation in sector returns as measured by standard deviation) increased from 2.5% in Q2 to 6.7%, above the long-term average of 6.0%. Energy and materials were the most heavily underperforming sectors, although healthcare had the largest negative contribution to the S&P 500 due to its greater weight within the index. Energy stocks were down across the board on sharply lower crude oil prices, as oversupply and falling demand led to a price correction of -24.2%. Concerns that a weakening Chinese economy would reduce demand for commodities also hurt precious and industrial metals prices, having an equally negative effect on the materials sector. Healthcare sold off considerably towards the end of the quarter when investors took profits, spooked by Hillary Clinton's comments around eliminating price gouging for specialty drugs. Such large, indiscriminate price swings are not unusual for the momentum sector where many companies produce no current earnings or revenue.

Outperforming sectors included utilities and consumer staples, not surprisingly. Amid market sell-offs, investors often favor more defensive sectors where companies have non-cyclical business exposures. Additionally, these dividend-rich sectors also benefitted from subdued interest rates as investors continue to see them as bond proxies, and share prices, like bonds, have negative correlation to interest rate movement. Consumer discretionary stocks also outperformed, despite returning -2.56%. The sector's quarterly performance was driven more by individual constituents, rather than themes as in utilities and consumer staples. Amazon[1] (internet retailers) and Nike[2] (footwear), labeled accordingly in the Market Map on the right, experienced significant gains after both reported strong Q2 operating results.

S&P 500 Market Map



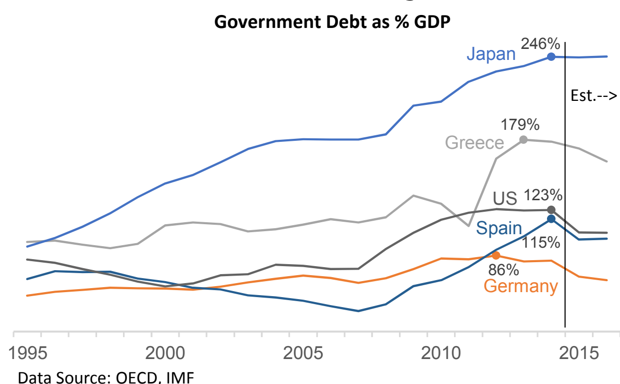
Overseas Markets

Volatility remained high during the third quarter as a number of market-shaking events occurred. China took surprise measures to prop up its market in the face of slowing growth, Greece's solvency remained in question as the country went mano-a-mano with its European creditors, and emerging markets continued to feel the dual impact of the slowdown

in China and falling commodity prices. The IMF announced it was, again, lowering its global growth forecast for the remainder of this year and into 2016.

The Chinese economy continued to slow during the quarter amid its transition away from a manufacturing and industrial-based economy into a service-based, consumer-driven one. Industrial profits fell 8.8% in August from a year ago, creating concerns that China's economy may be slowing more than expected. Beijing is expected to report growth of 6.5%-7% this year, down from 7.3% last year. This growth slowdown has had an adverse impact on peripheral Asia as well as many other major emerging market economies such as Russia, Brazil, and South Africa, which until recently have been significant contributors to global economic growth.

The slowdown in Chinese growth was exacerbated by a market panic in August that led the Chinese government to step in with additional cuts to interest rates and the required reserve ratio as well as both official and unofficial intervention in the equity market. Despite these efforts, the Shanghai Composite experienced its largest two-month drop since 2008, falling 14% in July and 12% in August. The People's Bank of China (PBoC) surprisingly devalued the renminbi on August 11. The renminbi had been trading in a 2% band around 6.20 yuan/US dollar since March. The 1.8% reduction in the daily Rmb/dollar fixing resulted in a 2.6% depreciation in the renminbi by August-end, its largest monthly decline since 1994. On August 24, markets suffered another dramatic decline largely due to the lack of accommodative action by the PBoC. The following day the PBoC announced its fifth round of interest rate cuts since November 2014. It remains to be seen whether China's economic transition will ultimately be a smooth one, or if China will suffer a "hard landing" (abrupt slowdown) or even a recession.



The possibility of another recession appeared as Japanese industrial output fell unexpectedly in August, the second straight monthly decline. Economists believe that the disappointing results might spur Prime Minister Abe's administration and the BOJ to take additional stimulus measures to prop up an economy that has shown lower growth than promised by Mr. Abe. Government data shows that output of goods, including both industrial and consumer products, fell 0.5% in August, following a decline of 0.8% in July. The figure surprised significantly to the downside as a consensus forecast for a 1.0% increase was widely held. Output for Q3 is now projected to fall 1.1%, after a 1.4% drop in the second quarter, according to the Ministry of Economy, Trade and Industry.

At the quarter close, the IMF released a report noting that "real goods exports from Japan have remained broadly flat during the past few years despite a sharp depreciation of the yen since late 2012." The report put the depreciation of the yen at about 35% in real effective terms since late 2012, with exports currently at 20% below the level predicted. Prime Minister Abe is focusing on economic growth and the higher tax revenue it should bring over austerity as a way to address Japan's burgeoning debt crisis, the result of low economic growth and a failure to curb increases in social security spending for the aging population. However, a government debt to GDP ratio of well over 200%, the largest in the developed world, is a considerable challenge to overcome. There is growing belief among economists that the negative data will spur additional stimulus measures from the BOJ.

Europe, which had begun to show signs of growth last quarter, became embroiled in the saga that is Greece. As the second quarter ended Greece was in a stand-off with its creditors over access to additional bailout financing. Greeks had resoundingly voted "no" to creditors' terms. However, fears that a default could send investors into a panic, pulling money out of not only Greece but other questionable European economies brought both sides to the table. Early in July, Athens formally asked for a 3-year bailout from the Eurozone's rescue fund and pledged to start implementing economic-policy changes by mid-month. However, any agreement by European leaders was contingent upon Prime Minister Alexis Tsipras reversing his party's stance on pension cuts, tax increases and other austerity measures after five months of rancorous negotiations. Germany, while stating that the Eurozone was prepared for a Greek exit, indicated that any multiyear aid program would require strong measures including changes to labor laws, product markets and the privatization of state assets that had been previously dropped from negotiations.

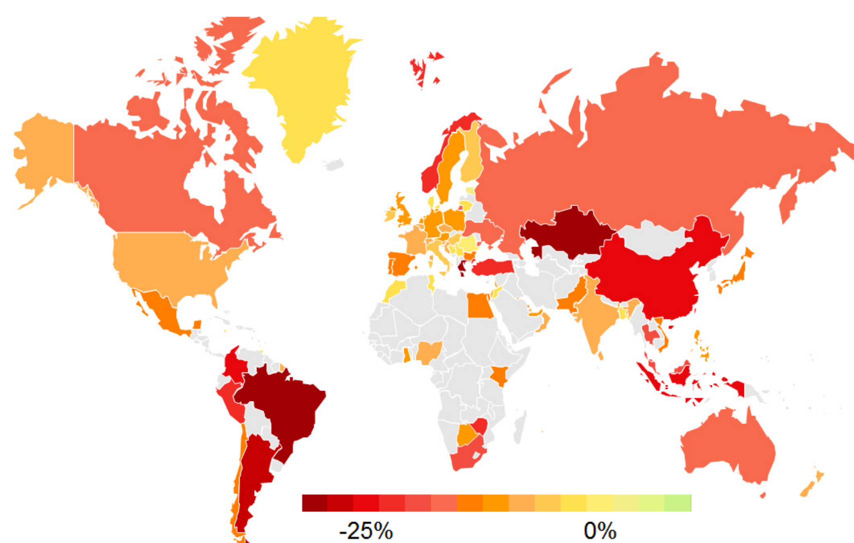
Foreign Stock & Bond Indices - Total Returns

MSCI Broad Indices	3Q15	Barcap Global Indices*	3Q15
World Index	-8.45%	Global Aggregate	1.23%
EAFE (Developed)	-10.23%	Pan-Euro	1.05%
Emerging Markets	-17.90%	Asian-Pacific	1.40%
		Eurodollar	0.62%
MSCI Regions	**3Q15**	Euro-Yen	-0.41%
Europe	-8.69%	Other Currencies	-8.42%
Japan	-11.80%	*Unhedged	
Pacific ex-Japan	-15.97%		
Latin America	-24.29%		

In mid-July, the European ministers ended lengthy talks in Brussels after completing the final elements of a bailout deal. The agreement granted Greece as much as €86 billion euros (about $95 billion), during the next three years. Sticking

points had included the role of the IMF and the possibility of reducing Greece's debt-repayment burden and the process for recapitalizing the country's banks. The agreement allowed a €13 billion disbursement from the European Stability Mechanism, the Eurozone bailout fund, to allow Greece to repay €3.2 billion to the ECB to avoid a debt default. The decision offered a longer-term approach to financing its staggering debt, which currently stands in excess of €315 billion, around 180% of GDP. Terms were also agreed upon to accelerate the establishment of a fund to manage the proceeds from the privatization of Greek state assets.

Adding to the news of slow growth Eurostat, the EU's statistics agency, said that consumer prices in the Eurozone fell in September for the first time since the ECB launched its program of government bond purchases in March, raising concerns of a possible slide into deflation and increasing pressure on policy makers to counter this renewed threat. The drop in consumer prices, down 0.1% from a year-ago, was driven largely by lower energy costs. But the renewed decline raises the specter of deflation, a drop in prices, which could make it more difficult for European governments and businesses to repay debts. The drop in consumer prices came as a surprise, since economists had expected no change. Inflation has been below 0.5% since July 2014. Excluding food, energy and other volatile items, core inflation was unchanged at 0.9%. However, the good news is that lower energy costs, combined with a weaker euro, may provide a tailwind to the modest recovery in the zone.



Falling consumer prices will put added pressure on the ECB to shore-up its €60 billion-a-month bond-buying program, intended to run through September 2016. The ECB is utilizing quantitative easing to raise inflation, and expectations of future inflation, by increasing the supply of money and reducing borrowing costs. At this time it remains unclear that stagnant or falling prices are weighing on growth. Consumer prices in Spain fell 1.2% in September, yet its economy has led the Eurozone's recovery the past year with increasing employment. In Germany, where consumer prices slid 0.1%, unemployment has fallen and consumer spending has posted steady gains. In September, the ECB lowered its inflation forecasts and warned consumer prices may remain weak due to the slowdown in China. A number of European policy makers have said they would consider additional stimulus measures if it appears likely that they will fail to reach their inflation target of just under 2% within the next two to three years.

The Latin American economy continued to suffer as falling commodity prices, political scandals, and fears surrounding the potential negative impact of a US interest rate hike have turned the region into one of the worst emerging market performers. The IMF recently cut its 2015 growth forecast for Latin America and the Caribbean by 0.4%, to just 0.5%. That figure could shrink even further if commodity prices remain on their downward trajectory and the slowdown in China, the biggest buyer of Latin American commodities, continues.

Brazil's economic and political crisis remains at the forefront. Dilma Rouseff's corrupted regime, the bear market in oil as well as falling revenues from soybean and iron ore exports to China, and an overall deceleration in Brazilian economic growth have served to drop the real over the past year by 39% against the dollar. On September 9th S&P's Ratings Services downgraded Brazil's sovereign debt by one peg to BB+, citing political challenges to the government's efforts to balance its budget. This is the first time Brazil's sovereign debt has been in junk territory since 2008. S&P maintained a negative outlook as well, indicating at least a 1-in-3 chance of further downgrades. This downgrade is yet another blow to the government's credibility with investors. The fallout from the Petrobras scandal has paralyzed key sectors of the economy, leading to even more near-term uncertainty. This tumultuous environment has unsurprisingly resulted in a recession that most economists expect to last into 2016.

Focus On: *Socially Responsible Investing*

Socially responsible investing (SRI) emphasizes the importance of well-governed social, environmental and economic systems. The SRI philosophy connects these factors to both superior risk-adjusted long-term performance for shareholders and the accrual of external benefits to the general public. While there is no consensus on how "responsible" is defined, funds managed under a socially responsible mandate typically underweight or avoid investment in companies acting in

violation of certain ethical or religious values, externalizing their costs or otherwise impairing social welfare. The result is typically a shift in emphasis from pure-profit to a deeper consideration of the complex tradeoffs companies must make between short-term profit, long-term sustainability, and external effects.

Socially responsible investing has roots dating back to the early days of the US. Eighteenth-century Methodist movement founder John Wesley established a framework for social investing built upon Christian values, benefiting the local community, and avoiding harm to others. As such, he and his followers opposed investment in industries such as the slave trade and chemical production. During this period, SRI was mainly faith-based. Investors avoided "sinful" industries, such as those involving alcohol, gambling and other vices. As other social issues came to the fore of public discourse, socially conscious investing expanded to include concerns both outside the social arena and far removed from any religious doctrine. SRI is a continually evolving space. The modern era of SRI came about in the 1960s as investors sought to address gender equality, civil rights and ethical business practices around labor. Later, environmental and governance issues gained traction alongside social issues to form the current "ESG" space.

Religious:
Abortion/Contraception
*Social Vices**
Human Rights
Stem Cell Research

Environmental:
Pollution
Climate Change Impact
Sustainability
Beneficial Products/Services

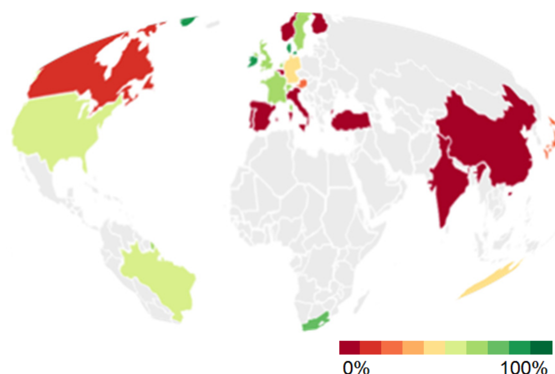
Social:
Human Rights
Consumer Protection
*Social Vices**
Animal Welfare

Governance:
Employee Benefits
Executive Compensation
Transparency
Management Structure

**Alcohol, Tobacco, Weapons, Pornography, and Gambling*

Founded in 1984, the US Social Investment Forum (US SIF), now the Forum for Sustainable and Responsible Investment, has been actively involved in promoting ESG investment criteria for decades. According to the US SIF, as of 2014, one-sixth of professionally managed assets ($6.57 trillion) in the US was invested according to SRI strategies, with $4.3 trillion in funds applying ESG factors (up from $12 billion in 1995). The number of ESG funds is also reported to have grown from 55 to 925 over this period. However, SIF figures rely on self-reporting of investment managers through an informal survey rather than actual commitments, as on a fund prospectus. The amount of assets invested with a specific mandate or restriction towards SRI is, in reality, much smaller. Sustainable and responsible mutual funds offered by US SIF's institutional member firms currently number just over 200 and represent only $120 billion, less than 1% of the total AUM for all US mutual funds. Broader estimates place SRI mutual funds at a number close to 500. Yet, little more than a dozen socially responsible mutual funds have individually attracted over $1 billion in assets compared to thousands of conventional funds. Separately managed accounts, which formed the basis for many SRI mutual funds, continue to be the largest collective of socially responsible assets, but are inaccessible to most retail investors. Private equity funds, hedge funds, ETFs, and other vehicles also can be found in SRI flavors as niche products.

In 2006, another influential body in ESG investing, the Principles for Responsible Investment (PRI), was created through a UN-sponsored initiative. Since inception, the number of global signatories to the PRI has steadily increased to include 916 investment managers, 289 asset owners and 190 professional service partners. PRI signatories commit to adopt and implement, where consistent with fiduciary duty, six voluntary and aspirational principles. Although implementing the principles is not mandatory, in order to increase accountability, the PRI requires annual reporting on the progress made towards their implementation. A map depicting the percentage of investment managers who are PRI signatories by country is shown [right]. Only the top 500 investment managers, by AUM, were counted.



In 2008, the Department of Labor (DOL) published guidance on interpreting ERISA's rules with regard to "economically targeted investments" - investments selected for the economic benefits they create apart from their investment return to the employee benefit plan. It states that fiduciaries may not select an investment based on factors outside the economic interests of the plan until they have concluded, based purely on economic factors, that such an alternative investment option is of equal or greater value. The US SIF has requested a withdrawal of the DOL's interpretation of ERISA's rules on investing in sustainable investments. While little regulatory oversight exists regarding socially responsible investing in the US, several European countries and Canada have set firmer guidelines and reporting requirements around the consideration of ESG factors throughout the investment process. Germany and South Africa require the consideration of ESG factors as part of a pension plan sponsor's fiduciary duty.

Process and Performance

Not only do criteria vary widely, but categorically, investment managers may apply positive and/or negative screens during their investment process. A negative screen simply excludes companies meeting certain criteria from possible inclusion in the portfolio. In contrast, a positive screen would penalize/reward companies according to specific criteria, making it relatively harder/easier for them to make it into the portfolio or reducing/enhancing their portfolio weight.

Negative screening is a logical choice for faith-based funds, but for practical purposes the screen may use a non-zero threshold in some cases, contrary to what investors may assume or prefer. Positively screened funds benefit from a greater degree of diversification and the ability to track a broad index more closely by staying invested in every major market sector. While philosophically, some investors may object to the use of positive screening, proponents contend that positive screening enables socially responsible investors to actuate change within the very companies they most desire improvement. By owning the shares of companies that need improvement, investors are able to exercise their voting rights to elect ESG-friendly board members and otherwise apply pressure toward pro-ESG outcomes. Critics argue that by investing in bad actors, they become more empowered to continue their current behavior. Another benefit of positive screening is that it rewards the companies that are most ESG-conscious relative to their competitors, spurring all companies to make attempts to address the low-hanging fruit of ESG issues, at least. It is reasonable to suggest that companies involved in gambling, tobacco production and many other faith-based exclusions do not need to exist, let alone receive public investment. However, ESG issues involve industries that are necessary, or at least central to our current societal structure. So, in many ways positive screening makes sense for ESG investing.

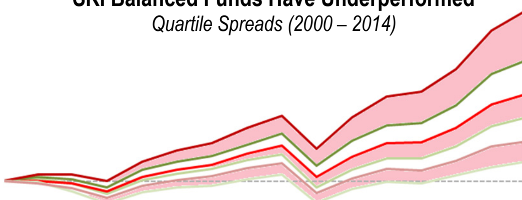
So far we have addressed the crowd of socially responsible investors driven by personal conviction, but there is another class of investor that may be drawn into SRI in hopes of achieving superior investment performance. While the data available on SRI funds has expanded considerably over the past decade, what has occurred over a single market cycle is likely more happenstance than intrinsic truth. Further complicating the matter, SRI implementations vary considerably both from fund to fund and across time. Some empirical research has shown select factors common to SRI (e.g. gender diversification among executives) to have significant effects on stock performance - but any fund can, and will, apply such factors that have been shown to work. Under established Modern Portfolio Theory, constraints placed upon the investment universe or portfolio construction on a basis unrelated to expected returns, volatility or correlation are likely to result in suboptimal portfolios – that is portfolios with less reward per unit of risk. When a socially responsible negative screen eliminates an industry, the result is a more concentrated, less diversified portfolio.

One large-scale investment manager that serves a productive example of both positive and negative screening is Dimensional Fund Advisors (DFA). DFA offers mutual funds in ESG, faith-based and conventional variants, making for an interesting case study. DFA's "Social Core" portfolios, offered in US, International and Emerging Markets versions, negatively screen out a host of the usual religious exclusions, but subsequently follow the same process and models employed by their (larger) non-SRI strategies. Similarly, US and International "Sustainability Core" portfolios run by DFA largely invest in the same securities as DFA's conventional core equity alternatives, but apply a layer of positive screening to introduce a bias within the portfolio towards the companies that rank highest on ESG factors. Data from DFA, provides a helpful but unfavorable example by allowing us to isolate the SRI effect all-else being equal. Four of the five SRI strategies have produced a 5-year track record and all four of these have lagged the non-SRI variants. Annualized underperformance ranges from 25 to 75 basis points, net of fees.

SRI Top 5 holdings
Danaher
Motorola Solutions
Mondelez International
Gilead Sciences
CVS Health

Non-SRI Top 5 Holdings
Exxon Mobil
Microsoft
General Electric
Johnson and Johnson
JP Morgan

Expanding our research, we took the asset-weighted holdings of the top 20 socially conscious large and mid-cap equity mutual funds benchmarked to the S&P 500 and identified the largest active weights, both positive and negative. The top 35 overweights and top 35 underweights were cast into two distinct equally-weighted portfolios. The 10-year trailing returns from 2005 to 2014 for the socially responsible portfolio outperformed the non-SRI portfolio by 1.2% on an annualized basis. However, on a risk adjusted-basis the SRI portfolio fell slightly short as measured by Sharpe ratio due to high volatility in the returns produced by the portfolio.



Moving to balanced funds, where there are nearly two dozen SRI mutual funds currently active, we formed two peer groups. The first group (shown in green) is composed of socially conscious balanced funds. The second peer group (in red) is made up of the large number of balanced funds without a socially responsible mandate. Over the trailing 15 years, socially responsible balanced funds have consistently underperformed their non-

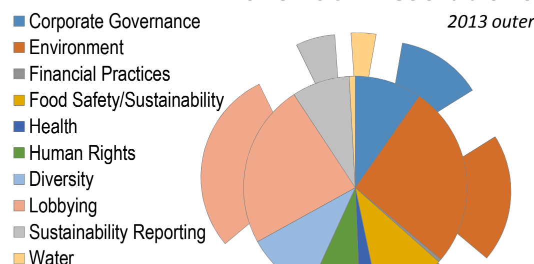
SRI counterparts. The chart to the left depicts the 25/50/75 percentile compounded performance within each peer group and the red bands show the degree of underperformance between the two groups. However, investors allocating their money in a typical 60/40 split to the largest social equity (Parnassus Core Equity) and largest social bond (PIMCO Total Return III) funds would have earned returns well within the top quartile of either group.

Individual cases where SRI would have been a blessing or a curse for returns abound. Philip Morris and ConAgra are both regarded as heavily socially irresponsible companies. Yet, that has not stopped either from outperforming the S&P 500 by a huge margin for the past several decades. On the other hand, Calvert, one of the most established socially responsible investment managers, avoided Enron completely, as would have many socially responsible funds had they existed 14 years ago.

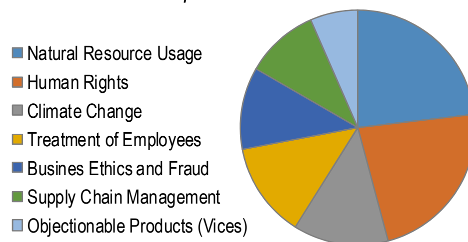
Whether or not SRI provides superior or inferior risk-adjusted returns remains up for debate. However, a certainty of higher fees for SRI funds exists in the mutual fund space. Returning to our example of DFA - their religiously-focused portfolios charge 5, 3, and 0 basis points of additional management fees on US, International, and Emerging Markets funds, respectively. ESG funds run a bit higher at 12 and 14 basis points of additional fees for US and International funds. The additional fees are DFA passing on the costs involved in SRI.

Increased Focus – The Key to Wider Adoption

The lack of consensus over what socially responsible investing means proves a hurdle to the success of SRI. When socially responsible activist investors band together, they have the potential to effect a significant change on the companies in which they invest. However, disagreement over what factors are important and how to prioritize them, weakens any voting power they might hope to wield. Regardless, ESG-focused shareholder resolutions are on the rise. A categorical breakdown in resolutions sponsored by members of the Interfaith Center on Corporate Responsibility (ICCR) is shown to the right.



Picking among SRI options also creates problems for plan sponsors who might add a socially responsible option to their defined contribution plan lineup. While the widely varying implementations of SRI make it possible for many investors to find an option that caters to their own personal values, it is impractical to offer multiple SRI options within most retirement plans. Whichever SRI fund is chosen will appease certain participants but disgruntle others. Additionally, plan sponsors must concern themselves with the amount of education needed to substantially inform their participants on this unique investment product. Given these hurdles, alongside DOL guidance, it is unsurprising that take-up among DC plans is low. Separate accounts have been, and continue to be, the biggest success story in SRI by providing a custom fit to the wealthy individuals, foundations, trusts, and religious organizations with a distinct view on socially responsible investing.



When Harry Markowitz introduced mean-variance optimization in 1951 he laid the groundwork for Modern Portfolio Theory (MPT), which has served as the basis for formal investment decision-making for decades. The idea that investment performance can be distilled into just two metrics, expected return and covariance (a combination of volatility and correlation) may now seem almost obvious. However, it took time for the financial community to absorb this concept and adapt. Although it is too early to award Universal Owner Hypothesis or SRI such a coveted status as to be on par with MPT, especially in its current disorderly, almost confused state, it is a space worthy of attention. The added emphasis on social welfare and externalities goes beyond utility curves and is, at least for now, not easily quantifiable. Yet, the philosophical underpinnings of SRI have an unshakable logic that provides a platform, if not common language, for discussing how an individual investment in a single company produces more than just a single return profile, but impacts investment in other companies, the environment, infrastructure, government, health, and countless other areas. Will carbon credits be followed by something more general and widespread – ESG credits? Will financial analysts being born today wonder how ESG factors were not integral to investment decisions prior to the 21st century?

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