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Trust UPDATE

CITIZENS BANK
A Bank Built For You

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More than returns, more than risks

The debate continues over "impact investing."

The headline in a June 16, 2019, *Wall Street Journal* article was surprising: "Calpers' Dilemma: Save the World or Make Money?" The California Public Employees' Retirement System was one of the earlier proponents of the idea of linking social activism to investment strategies. That meant disinvestment in disfavored firms, such as tobacco companies.

Now that approach has been challenged as unnecessarily limiting, potentially sacrificing higher returns on pension investments. For example, according to a consultant's report, the avoidance of investments in tobacco companies has cost the pension fund $3.5 billion in foregone returns. On the other hand, some divestments have been profitable, or have avoided losses.

The Calpers board resisted calls for divestment in gun manufacturing companies last year, as well as moves this year to avoid private prison companies and companies with ties to Turkey. A comprehensive review of all the divestment policies will be undertaken in 2021.

Background

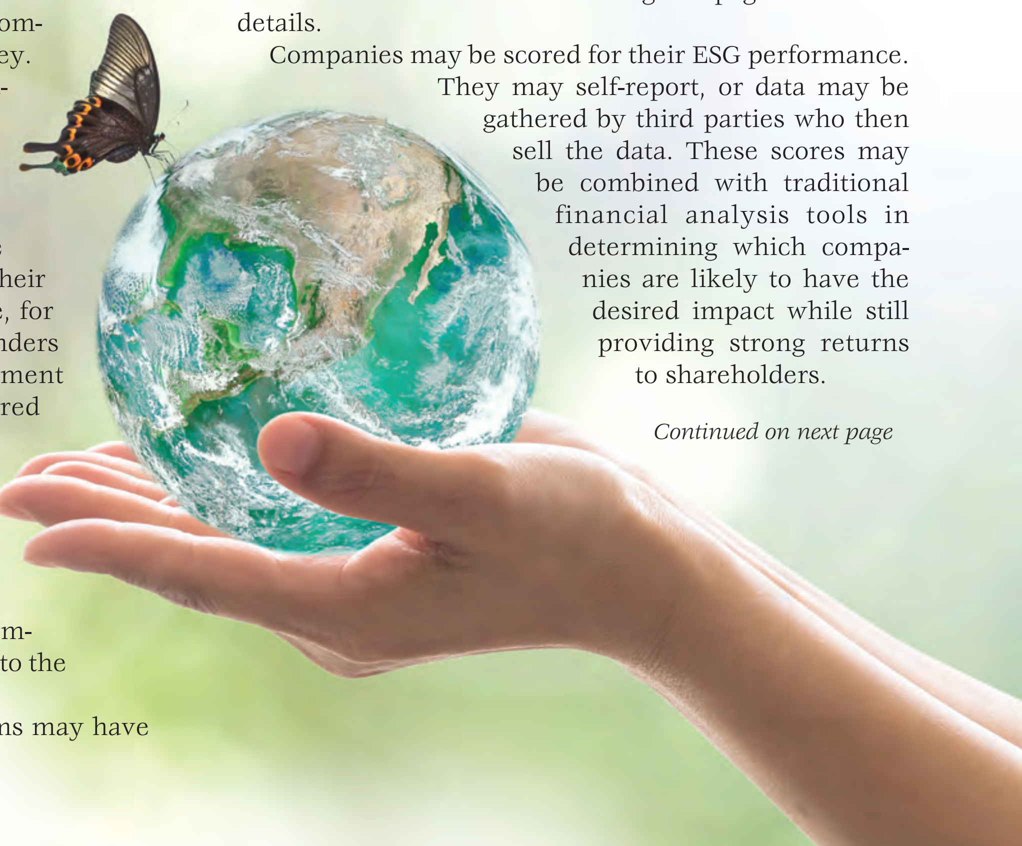
The idea that investments may have a moral dimension is not new and may be traced to the 1700s. The Quakers forbade their members to participate in the slave trade, for example. John Wesley, one of the founders of Methodism, advised avoiding investment in companies with practices that injured employee health.

In the 1990s the idea of "socially responsible investing" took shape. The initial idea was to use negative screening to avoid companies that traded in "sin" or "vice," such as tobacco companies, gun manufacturers, casinos, and liquor companies. Some people added oil companies to the proscribed category.

Although screening out disfavored firms may have made investors feel virtuous, it didn't affect the fortunes of those firms in a material way. In fact, the "vice stocks" generally outperformed the market as a whole, because those companies tended to be rather profitable, paying generous dividends to their shareholders.

A less constricting version of socially responsible investing has emerged in recent years, one that employs positive screens or themes as well as exclusions. Three categories of factors are involved: environmental, social, and governance (ESG). An environmental focus may look at carbon emissions, water stress, renewable energy, or pollution. Social factors might be diversity, inclusion, labor, employee welfare, or data security. Governance issues might touch upon independent directors, audit standards, women in leadership, and executive compensation. See "What is ESG investing" on page 2 for more details.

Companies may be scored for their ESG performance. They may self-report, or data may be gathered by third parties who then sell the data. These scores may be combined with traditional financial analysis tools in determining which companies are likely to have the desired impact while still providing strong returns to shareholders.



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Those in favor

Some have argued that companies with higher ESG scores are less likely to be disrupted by environmental problems, labor relations woes, or governance scandals, and as such may provide superior risk-adjusted returns. It's too soon to answer that question with complete confidence.

Professor David Snowball made the case for investing in ESG mutual funds in the June 2019 issue of *AAII Journal* ["Investing in Climate Change," p 12]. He notes that the number of ESG mutual funds and exchange-traded funds rose from 235 to 351 in just one year, citing Morningstar data. Average inflows have exploded from about $135 million in 2012 to $5.5 billion last year. He argues that as millennials enter their peak investing years, they are likely to favor "responsible" businesses, and that should boost returns for those companies. It could be the wave of the future.

On the other hand, Daren Fonda, contributing to a Barron's Special Report on "Investing With Purpose," observes that mutual funds that refer to ESG in their prospectuses held just $161 billion at the end of 2018, compared to the total $22.1 trillion in U.S. fund assets. ESG funds appear to be a niche product at this time, essential offerings for a few investors but not a critical priority for many others.

Several obstacles will need to be overcome. One is definitional, as there is some uncertainty about what counts as an ESG asset or strategy. Another is that only 5% of 401(k) plans offer participants an ESG option, and these plans are the primary investment vehicles for many, many families. But Labor Department guidelines can make such offerings problematic for plan sponsors.

These are issues that investors will want to keep abreast of. ☐

What is ESG investing?

"ESG" stands for Environment, Social, and Governance. Concerns about the environment include:

- **Climate change policies, plans, and disclosures.**
- **Greenhouse gas emissions goals.**
- **Carbon footprint and carbon intensity.**
- **Water-related issues and goals, such as usage, conservation, overfishing, and waste disposal.**
- **Green products, technologies, and infrastructure.**

Social concerns may include:

- **Employee treatment, pay, benefits, and perks.**
- **Employee safety policies including sexual harassment prevention.**
- **Diversity and inclusion in hiring and in awarding advancement opportunities and raises.**
- **Ethical supply chain sourcing, such as conflict-free minerals and responsibly sourced food and coffee.**
- **Public stance on social justice issues, as well as lobbying efforts.**

Governance covers such areas as:

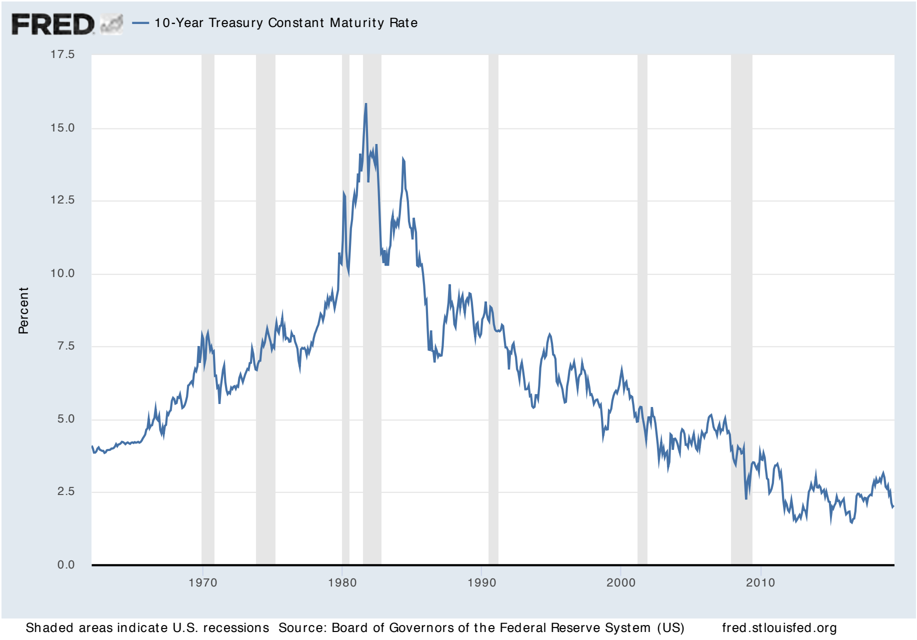
- **Whether executives are entitled to golden parachutes (huge bonuses upon exit).**
- **Diversity of the board of directors and management team.**
- **Whether chairman and CEO roles are separate.**
- **Dual- or multiple-class stock structures.**
- **Transparency in communicating with shareholders, and history of lawsuits brought by shareholders.**

Negative interest rates

Interest rates were on a fairly persistent upward path through the 1960s and 1970s, as shown in the graph here from the St. Louis Federal Reserve Bank of the rates for 10-year Treasury bonds. The rate peaked at over 15% early in the Reagan presidency, when the Federal Reserve Board took strong anti-inflation measures. Since then, interest rates have declined, and they remain at historically low levels.

Rates tend to fall during recessions, as the Fed lowers short-term interest rates to stimulate the economy. In the graph, recessions are indicated by the grey shading. Since the 1980s, rates have not bounced back as the economy has expanded.

After the most recent recession, interest rates were held deliberately low for years to create and support an economic recovery.



Going negative

Some interest rates fell below zero during the 2008 financial crisis, as worried investors sought maximum safety. With a negative interest rate, a lender is effectively paying the borrower to borrow money. The longer the money is held, the less the lender eventually will receive.

The 2008 experience with negative rates was not a temporary anomaly, as policymakers had hoped. For example, interest rates on French government bonds turned negative in June, and in July the government issued 10-year bonds at an interest rate of -0.13%. The European Central Bank lowered its key deposit rate to 0.1% in 2014, and has since lowered it further to -0.4%.

Portfolio impact

The Fed has shifted from increasing interest rates to cutting them. That's not great news for bond investors, a group that includes a great many retirees living on their portfolio income. Those who have employed "bond ladders" to increase returns while controlling risks are finding slim pickings for reinvestment as their bonds mature.

Might the stock market be a better alternative? Hard to say—one school of thought holds that these persistent low interest rates are a sign that global economic growth is slowing, and that central banks won't be able to do much about it. As a wise man once said, predictions are hard, especially about the future.

If you have questions about how persistent low interest rates may affect your portfolio management, we are here to help explore some possible answers. Call on us at any time. ☐

The Chairman's observation

I want to focus a little more closely on the challenges we face today. For a reference point, at the time of the 1999 conference, the United States was eight years into an expansion; core inflation was 1.4 percent, and the unemployment rate was 4.1 percent—not so different from today. Macroeconomists were puzzling over the flatness of the Phillips curve, the level of the natural rate of unemployment, and a possible acceleration in productivity growth—questions that are also with us today.

The big difference between then and now is that the federal funds rate was 5.2 percent—which, to underscore the point, put the rate 20 quarter-point rate cuts away from the ELB [effective lower bound on interest rates]. Since then, standard estimates of the longer-run normal or neutral rate of interest have declined between 2 and 3 percentage points, and some argue that the effective decline is even larger. The combination of lower real interest rates and low inflation translates into lower nominal rates and a much higher likelihood that rates will fall to the ELB in a downturn.

—Federal Reserve Board Chairman Jerome Powell, June 4, 2019

Enforcing a charitable gift

Sherlock Hibbs, a 1926 graduate of the University of Missouri, served in World War II and then went on to a successful career in finance. During his career he observed the fundamental importance of free markets, private property, and limited government. Hibbs' will provided $5 million to the University of Missouri, with the stipulation that the money would be used to endow three chairs and three distinguished professorships limited to "dedicated and articulate" disciples of free market economist Ludwig von Mises and his Austrian School of Economics. Hibbs died in 2002.

The will included an unusual enforcement clause, to see that the donor's directive would be implemented. If the University of Missouri should fail to honor his wishes completely, the bequest passes to a contingent beneficiary, Hillsdale College. The TaxProfBlog now reports that Hillsdale is taking the responsibility very seriously, and it has filed suit against the University of Missouri for its failure to comply. The University allegedly found the directives "distasteful" and was concerned that its Business School could be "held hostage by a particular ideology." Hillsdale hired former Missouri Governor Jay Nixon to represent it in the lawsuit. He said, "Hillsdale College looks forward to thorough discovery into why the University of Missouri changed the terms of Mr. Hibbs' gift."

Charitable gifts holding steady

Charitable giving by Americans set another record in 2018, reaching an estimated $427.71 billion, according to Giving USA. This was up only slightly from the earlier record of $424.74 billion set in 2017. On an inflation-adjusted basis, the organization reported the figure as a 1.7% decline. Giving by foundations was up sharply, well above inflation, as was giving by corporations.

There had been widespread fear that the doubling of the standard deduction, leading to a dramatic decline in the number of itemizers, would be accompanied by a drop in charitable giving. That does not seem to have happened, although individual giving did decline by 1.1%. Another reason for the volatility in individual donations might have been the drop in the stock market in 2018's fourth quarter, when much charitable giving takes place.

Giving by bequest was unchanged from 2017 to 2018, despite the doubling of the amount exempt from federal estate tax. It would appear that, for most private philanthropy, tax benefits are at most a secondary consideration. ☐