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EVOLVING PRINCIPLES CHANGING ESG SPACE

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When it comes to environmental, social and governance investing with ETFs, financial advisors may use funds that focus on the “e” and the “g,” as those are easy-to-measure financial metrics.

Some advisors may have struggled with understanding the “s” part of ESG criteria, since the success metrics were harder to measure. That’s changing, and it’s giving rise to ETFs with a narrower focus on social principles.

James Lumberg, co-founder and executive vice president of Envestnet, says there are two reasons the ETF industry is starting to see new developments for principles-based investing.

First, greater corporate transparency and reporting allows fund providers to find securities aligned with specific social principles. Second, there’s a growing industry around creating ratings to score ESG criteria, with firms like MSCI and Sustainalytics as two examples.

“These [firms] allow the fund provider to efficiently identify securities that align with whatever level of interest, whether it’s faith-based, social, environmental or governance,” Lumberg said. “With the ability to offer securities based on all of these different metrics, that’s been a very important enabler to the industry.”

Some of these more narrowly focused principles-based funds include the newly launched InsightShares Patriotic Employers ETF (HONR), which has an expense ratio of 65 basis points and $2.5 million in assets under management. It debuted in January and includes companies that encourage veteran workplace participation, based on a “military-friendly employers” list. A percentage of the fund’s revenue is donated to military-supportive charities.

Another, the Workplace Equality Portfolio (EQLT), selects firms that support gay, lesbian, bisexual and transgender employees. It has $20.8 million in AUM and a 75 basis point expense ratio. InsightShares also rolled out its own fund focused on support for LGBT employees in January, the InsightShares LGBT Employment Equality ETF (PRID), which charges 65 basis points and tracks an index that relies on data provided by the Human Rights Campaign.

Rise Of Impact Investing

Impact investing is a growing part of ESG, where funds seek ways to make positive improvements, whether through buying securities in companies that already align with the social interest, or through proxy voting to change or reward good corporate behavior.

Two funds expected to be launched in the first quarter from Impact Shares take a different spin on this concept by working with established nonprofits creating positive social change: the Impact Shares YWCA Women’s Empowerment ETF (WOMN) and the Impact Shares NAACP Minority Empowerment ETF (NACP).

Ethan Powell, founder of Impact Shares, says there are a few reasons the social part of ESG was given the short shrift before. When ESG funds focus broadly on social responsibility, “you really lose a lot of the interest and passion that people have, because no matter how well intended … I may have a different conclusion [on social responsibility] based on what my values are.”

Narrowly focused principles-based ETFs focus on specific social issues. “There’s a presumption that we have a common system of values, and we don’t,” he noted. “Social impact investing is best done when you’re trying to achieve a very specific social code.”

Powell said his firm worked with the NAACP and YWCA on the social screens in order to maximize exposure to what the groups are trying to achieve, and Impact Shares uses those criteria to create the index methodology. They're giving all the advisory proceeds back to the groups.

A Christian Lens

Regarding the idea that not everyone's view of social responsibility is the same, Inspire Investing has launched four ETFs—three equity and one fixed-income ETFs that have a combined AUM of $122 million—with a "biblically responsible" theme. That includes screening out traditional targets such as alcohol and pornography, but also "the LGBTQ lifestyle" and countries that discriminate against Christians, while including companies Inspire says are "doing amazing things like working to cure cancer."

To ensure adherence to the screens, Inspire uses publicly available data on each company's primary business activities, products and services to assign a proprietary Impact Score. Inspire donates 50% or more of corporate profits each year to Christian ministry.

There are some Christian-based mutual funds available, but in the ETF world, there weren't choices available for conservative Christians to invest in alignment with their values, says Robert Netzly, president and chief executive officer of Inspire Investing.

This isn't the first faith-based ETF. A few years ago, FaithShares had a suite of funds, but those closed without gaining a footing. Netzly notes that what makes his funds different from FaithShares is the very strict screening on issues important to conservative Christians.

"We've been very clear that this is what we stand for. We've gotten a lot of flak—I'm sure you've seen in the news—particularly around the issue of LGBT activism," he said. "We don't want to invest in companies that're going to work against our deeply held values, so we've really firmly planted ourselves in that conviction. We're seeing investors rally around that."

Another fund with a religious focus, the Global X S&P 500 Catholic Values ETF (CATH), has $135 million in assets and focuses specifically on Catholic beliefs.

Jeff Finkelman, research associate, impact investments at Athena Capital Advisors, says the industry is seeing more of these ETFs launch because of the stated desire on the part of millennials and others for more principles-based investing options.

"On one hand, I think it's exciting for investors that have an interest in accordance with their values, or who see ESG as an investment opportunity, or as a way to mitigate risk, that there are potentially more viable options for them," Finkelman said.

However, he notes, like any ETF investment, advisors need to dig into what kind of exposure the fund offers and how it fits into the overall portfolio. Many of these funds have large-cap tilts because of the benefits big companies can offer employees.

Plus, he says, some of the narrowly focused ETFs' methodologies rely on nonfinancial data, and there's not always transparency about the basis for criteria selection. Depending on how much weight the index assigns to those nonfinancial factors, the fund could overweight or underweight particular sectors or market caps in surprising ways because of the nature of the strategy.

When Athena implements an ESG strategy, even if its clients have very narrowly focused values objectives, "it's balanced against the needs of their investment portfolio in terms of risk/return, liquidity and all the other factors that go into building a well-balanced investment portfolio," Finkelman added.