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Wealth Management

FLASH REPORT

Eric D. Wheeler, CFP®
Branch Manager, Wheeler Wealth Management
306 Middletown Park Place, Unit B · Louisville, KY 40243
P (502) 200-7225 · F (502) 473-6562

ESG: Pros & Cons of Values-Based Portfolios

In recent years, more people have become aware of new thinking around environmental sustainability, workplace diversity, ethical decision-making practices and similar issues impacting both life and business. Investors are increasingly reflecting that awareness in terms of the types of stocks and other securities they buy—and avoid.

Investment portfolios that are guided in part or entirely by concerns about companies' workplace policies and broader societal impact are becoming popular, particularly among high-net-worth individuals and families. Example: According to Morningstar, $3.1 billion flowed into ***ESG funds***—which invest in companies with strong environmental, social and corporate governance efforts—in 2022, and more than 90 ESG funds were established that year.

Should you add these investments to your own portfolio?

It's important to first get a good handle on just what socially and environmentally focused investing entails. Broadly, ESG investing is designed to identify businesses that operate responsibly and effectively in (as noted) the areas of environment, social and governance. The goal is to allocate capital to those companies that meet or exceed certain standards in those three areas—or that are working hard to meet such standards—while avoiding firms that don't.

That focus often looks like this:

1. **Environment.** Climate change developments and threats are driving more companies to take actions to limit their environmental impact and mitigate climate risks that could hurt their financial health. Firms taking steps to reduce their "footprint" on the Earth are often prime candidates for ESG portfolios.

2. **Social.** This reflects companies' approach to a broad range of issues, both internal—employee hiring and compensation practices, workplace diversity and inclusion, employee development—and external (how the business works with its local community and government as well as with other businesses and customers to create overall social benefits).

3. **Corporate governance.** This is all about the practices, processes and controls that companies' management and/or board implement to make their decisions and oversee themselves. Governance is a broad category that can reflect a company's ethics, how it meets certain regulations, how it treats stakeholders in the business, the level of diversity among its leadership and a host of other concerns.

An ESG-focused investor might, for example, emphasize shares of businesses that focus on mitigating ocean waste or firms with a higher-than-average percentage of women in C-level roles. That investor might also avoid shares of companies that he or she believes erode important social or environmental conditions.

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KNOW THE RISKS

Interest in ESG investments is rising for numerous reasons. Chief among them:

1. **Alignment of wealth with values.** Some investors want their assets to reflect social and environmental causes and other factors that are most important to them, while looking to build their wealth in ways that don't conflict with their values. Seeking out investments in businesses that engage in *(for example)* fair trade sourcing of raw materials or improving the condition of land and water can enable such investors to, in essence, put their money where their mouth is.

2. **Return potential.** The top motivator for 39 percent of affluent individuals investing in ESG is higher returns, according to Capgemini. Spectrem found that 65 percent of investors think ESG investments have the potential to do as well as or better than the overall stock market—and those with the highest levels of wealth were most likely to expect market-beating returns.

That said, finding legitimately "do-good" businesses to invest in isn't as easy as spotting the organic label on a carton of milk. One potentially big risk is greenwashing—essentially, when companies mislead or overhype the extent of their ESG-related efforts. Examples of greenwashing might include a business that uses relatively little energy in the first place touting its new energy-efficient operations, or a company sponsoring diversity-related public forums and high-profile events while maintaining a poorly diversified workforce.

More than four in ten affluent ESG investors cite greenwashing as the biggest challenge with regard to this type of investing in the coming years, while 76 percent of investors surveyed by Spectrem are concerned about the risk of "making an investment that has been greenwashed."

A related risk is being able to accurately assess a company's ESG-related efforts to determine if they're having the type of impact that could make them a potentially strong investment opportunity. ESG investors have set up various criteria and metrics they use to judge companies' initiatives and score them. However, the standards vary depending on who is doing the assessing—making it difficult to rely on one score or rating as the final word on a company's overall ESG-ness. What's more, the ratings might be based on information coming from the companies themselves—creating another opportunity for greenwashing. The good news is that there's a movement toward a universal set of standards.

Another potential risk: By avoiding certain investments due to ESG factors, investors may end up becoming heavily invested in a relatively small number of market sectors or securities. That could expose investors to certain unexpected risks.

And of course, ESG investing *(similar to traditional investing)* may be subject to market risks, data accuracy challenges, regulatory changes, and liquidity constraints—risks that should be carefully considered.

Ultimately, ESG investing is becoming a significant component of some investors' wealth management plans—including investors with significant assets. Of course, that's not a good enough reason to make ESG a part of your portfolio. But the fact that this type of impact investment approach is getting attention from investors with sizable wealth does mean you may want to consider it when allocating your capital.