

BARRON'S

Sustainability Ratings Tell Half the Story

How a fund invests is only part of sustainability. Funds dedicated to sustainable investing use their heft to influence corporate behavior.

Lewis Braham 10/7/2017

If you want to beat the market by investing in companies with relatively clean environmental, social, and corporate governance, or ESG, records, buy the Vanguard FTSE Social Index fund. That's what Morningstar's new sustainability ratings, which award the Vanguard fund an "above average" rating, will tell you. But if you truly care about issues like climate change, gender and racial diversity on boards, and fair executive compensation, don't buy this fund.

Morningstar's ratings don't distinguish between funds that have an ESG mandate and those that don't: They assess how sustainable a fund's underlying portfolio companies are. But for some socially responsible investors, that's not enough. "To me, that's only half the story," says Jackie Cook, founder of Fund Votes, a Vancouver-based research firm that tracks how funds vote on ESG-related shareholder proposals. "Part of the value of a stock is its voting rights. To not incorporate how institutional investors are exercising those rights is missing a lot."



Despite its above-average rating, Vanguard FTSE Social (ticker: VFTSX) only supported 10% of 2017's 240 ESG-related shareholder proposals for its portfolio holdings, according to Fund Votes. Among the proposals it opposed were for increased climate-risk disclosure at oil-and-gas

company Devon Energy (DVN),* a review and report of business standards at scandal-plagued Wells Fargo (WFC),* increased board diversity at Apple (AAPL),* and 12 proposals for reports on gender pay gaps at companies.

The Vanguard fund even opposed a proposal to require rival fund company and holding T. Rowe Price Group (TROW) to review its voting practices and issue a report on climate-change-related shareholder proposals. That T. Rowe proposal was co-filed by socially conscious fund manager Walden Asset Management, which also submitted a similar proposal at Vanguard. Only in August did Vanguard finally concede to Walden this in a press release about it now being a more climate-risk aware firm.

Vanguard FTSE Social is not the only example, but it's an egregious one, since it actually has a socially responsible mandate. Its votes are largely in line with the rest of Vanguard—worse, in fact, as it averaged 14.7% ESG support in 2017. “Votes only tell part of the story, and we have a high threshold for proposal support,” Vanguard spokeswoman Arianna Sherlock wrote in an emailed statement.

Funds without a mandate are even more derelict in supporting ESG-related proposals. Take CGM Focus (CGMFX), which, with a 45.8% one-year return, bests 99% of its peers, and is the top-performing fund of the 203 U.S. large-cap funds that Morningstar rates above-average or high on sustainability. It supported none of the 18 ESG-related shareholder proposals for its portfolio holdings in 2017. Among the biggest well-rated funds, ESG support was especially bad. The \$97 billion American Funds Washington Mutual (AWSHX) supported just 15% of 172 ESG proposals; the \$66 billion Dodge & Cox Stock (DODGX), 21% of 61 proposals; the \$58 billion Vanguard Primecap (VPMCX), 8% of 119; and the \$21 billion BlackRock Equity Dividend (MDDVX), 4% of 119 proposals.

CGM Focus illustrates the problem with rating only portfolio holdings. Manager Ken Heebner's investment strategy has no sustainability mandate. (In fact, Heebner was a significant campaign donor to 2016 presidential candidate Marco Rubio, who opposed policies to address climate change.) CGM has a rapid-fire trading style with a 334% turnover ratio and a concentrated portfolio of stocks that can shift from sector to sector—including to polluters in the energy sector in which Heebner has invested heavily in the past—depending on his macroeconomic outlook. The ratings are merely a snapshot of the fund's current portfolio relative to its peers. CGM declined to comment.

Funds from firms that are ESG-oriented do vote on these measures. The median percentage of ESG proposal support was 74% for the 45 socially responsible funds rated high or above average.

BUT THE TRULY ACTIVE, socially responsible funds not only vote for ESG proposals; they also file them. “I think of engagement as on a scale,” says Leslie Samuelrich, president of Green Century Capital Management, which manages three socially responsible funds. “It starts with proxy voting, but someone else is putting the proposal on the ballot and you’re just being reactive when you vote. Last year, we filed 12 resolutions.” Green Century also lobbies institutional shareholders to vote for resolutions, and its Green Century Equity fund (GCEQX)

voted in favor of 92% of 149 ESG-related resolutions in 2017. It has a mandate to avoid fossil-fuel companies, unlike other funds that may only be temporarily light on the worst polluters.

Morningstar is aware of the ratings' limitations and plans to update them. "Proxy voting is an area we would like to eventually incorporate into our overall analysis of sustainable funds," says Jon Hale, Morningstar's director of sustainable investing research. Hale admits that concentrated, high-turnover funds like CGM Focus can be problematic to rate, but says most funds are more consistent. Moreover, the ratings are especially helpful for investors who may only have access to 401(k) plans with limited sustainability choices.

Hale says the largest fund families have long favored private engagement with portfolio companies on ESG issues over voting publicly for proposals. But increasingly, they've begun to differentiate themselves. Cook has been tracking ESG voting since 2004 and says up until 2017, Vanguard, Fidelity, and American Funds never supported a single climate-change-related proposal. But this year, Vanguard supported two—at Exxon Mobil (XOM)* and Occidental Petroleum (OXY)*—and American Funds supported 23.2% of ESG proposals, and Fidelity, 18.6%. Meanwhile, BlackRock, though its 16.4% overall ESG 2017 support is poor, has been launching a series of ESG-themed ETFs, which have a different proxy voting policy. They supported 77.1% of 2017's proposals. The iShares MSCI USA ESG Optimized exchange-traded fund (ESGU) is intriguing with its low 0.15% expense ratio. That makes it a better option for the socially conscious than Vanguard FTSE Social, which charges 0.22%.

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*As of September 30, 2017, Apple, Inc. comprised 0.00%, 1.32%, and 0.00% of the Green Century International Index Fund, the Green Century Balanced Fund and the Green Century Equity Fund, respectively. Other securities mentioned were not held in the portfolios of any of the Green Century Funds as of September 30, 2017. References to specific securities, which will change due to ongoing management of the Funds, should not be construed as a recommendation by the Funds, their administrator, or their distributor.

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