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Schultz Collins 2nd Quarter 2021 Market Review and Commentary

Stock markets continue to extend their gains from earlier this year, based on a fairly successful rollout of the coronavirus vaccine in the US, and the relaxing of restrictions on public gathering during the pandemic.

The overall global market, as proxied by the MSCI ACWI Index, returned 7.53% for the 2nd quarter, outpacing its gains in the 1st quarter by 2.85%[1]. The index is up 39.9% for the trailing 1-year period. Large US companies performed slightly better than the overall global economy. The S&P 500 index rose 8.55% during the quarter and is up 40.83% in the last 12 months. Small US companies have not done as well, but still advanced for the quarter. The Russell 2000 index rose 4.29% over the last 3-months. It's 62.08% return for the past 12-month period is mainly due to the small cap rally that occurred in the latter half of 2020. US Real Estate Investment Trusts posted their 3rd straight quarter of double-digit returns. The Dow Jones US Select REIT Index is up 11.76% for the quarter and 40% for the trailing 12-months.

Relative to the US, other developed markets are not recovering as well from the pandemic. The MSCI EAFE Index, a measure of international developed equity markets, has returned 5.38% for the quarter and 32.95% in the last 12 months. Emerging markets did not fare better either, with the MSCI Emerging Markets index up 5.12%, about a quarter of a percentage point less than developed markets. Emerging markets are up 41.39% over the trailing 12-month period, mainly due to stellar performance in the 2nd half of 2020.

Switching over to bond markets, in general, they have bounced back modestly. With US interest rates slipping slightly this quarter, the aggregate US bond index is up 1.83%, and the high-quality, US corporate bond index is up 1.7%. Over the trailing 12-month period, the US Aggregate Bond Index is down a third of a percent and the Intermediate-term US Corporate Bond Index is up 2.57%. Global bonds also rose modestly, with the FTSE World Government Bond Index returning slightly less than one percent for the 2nd quarter, putting its trailing 12-month return at about three quarters of a percent.

As fear of rising interest rates ease, the 10-year Treasury bond yield dipped slightly last quarter. The yield started at 1.61% in March, then inched up to 1.64% in April, then slid to 1.52% by June. Yields tend to fall as bond prices rise.

[1] Data provided by Morningstar and Dimensional Fund Advisor. Data is for illustrative purpose only.

The theme for this quarter's discussion is ESG, or funds with an emphasis on environmental, social and governance factors.

We are pleased to present some analysis and findings on ESG, based primarily on the CFA Institute's recent publication *ESG and Responsible Institutional Investing Around the World, A Critical Review*[2] by Pedro Matos.

ESG is a broad term that refer to the incorporation of environmental, social and governance considerations into an investor's portfolio decision process. Other terms like sustainable investing, responsible investing, socially responsible investing, and SRI are often used interchangeably with ESG. ESG factors are non-financial data that focus on environmental issues such as carbon emissions, societal impacts such as labor practices and governance criteria such as a company's board structure. The growth of sustainable investing continues to accelerate in the United States and it was reported last year that a third of US assets under professional management was invested in ESG strategies. There is no consensus on the exact list of ESG issues and their materiality as many of these issues are not reflected in traditional financial statements. In addition, ESG investing continues to evolve, hence, ESG implementation has not been universally defined.

There are many forces driving ESG investing including institutional investors and the regulatory environment. The top ESG concern by institutional investors is climate change, particularly carbon risk and related risks such as physical and transition risks. Studies suggest that carbon risk is largely already priced into markets. In the US, there is also partisan divide and active debate whether pension plan fiduciaries have a duty to include the consideration of ESG factors when making investment decisions. Under the Biden Administration, we expect another set of amendments from the Department of Labor that does not bar pension plans from considering ESG factors, while also upholding their fiduciary obligations. Given the number of high-profile ESG-related incidents, such as the 2001 Enron accounting fraud, the 2010 Deepwater Horizon oil spill and the Wells Fargo fraudulent checking account scandal in 2016, a new model of leveraging private capital to address ESG issues has been touted by CEOs and large pension funds. For example, Larry Fink, CEO and Chairman of BlackRock, wrote is his 2020 letter to CEOs that ESG risks should be analyzed with the same rigor as traditional measures such as credit and liquidity risk.

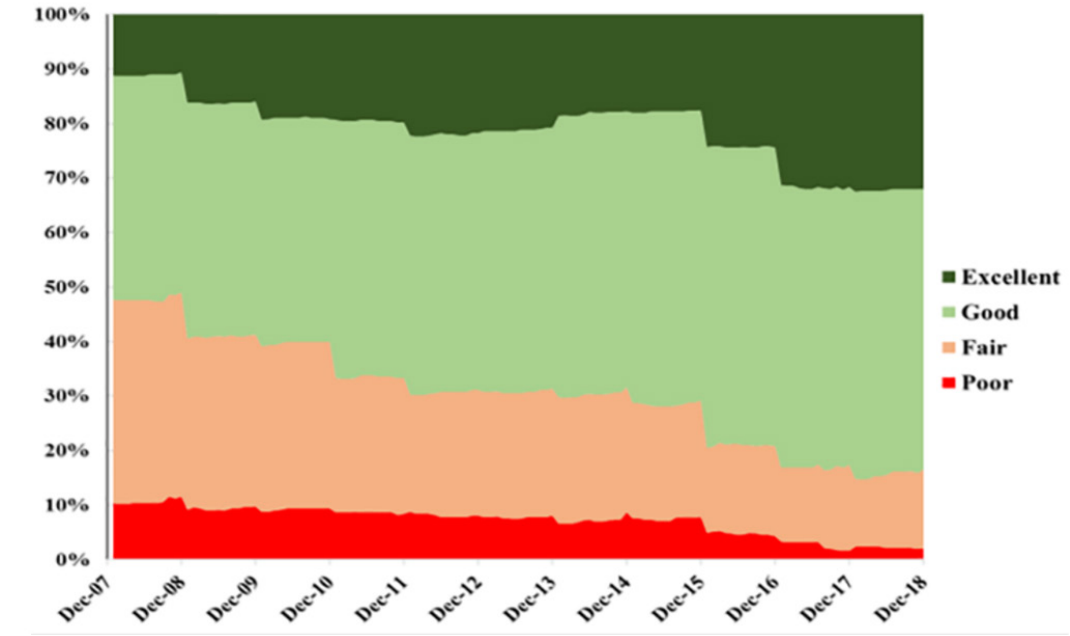
Are ESG factors impacting investment results? Research has found that corporate governance indexes and ratings may be backward looking and have no predictive power in government-related outcomes, such as accounting restatements or shareholder litigation. Also, what is the direction of causality? Is it more the case of "doing good by doing well" than "doing well by doing good?" It could be that instead of ESG making firms more profitable, more profitable firms have the resources to invest in areas that positively influence ESG. A study found little evidence that the average performance of ESG-focused funds in the United States and the United Kingdom differs significantly from that of conventional funds, and that there was some degree of underperformance in Europe and Asia Pacific. Other research

[2] Full link to article – https://www.cfainstitute.org/-/media/documents/book/rf-lit-review/2020/rflr-esg-and-responsible-institutional-investing.ashx

suggests that responsible investing has acted more as a risk management tool than as a strategy to enhance returns.

The rapid growth in the availability of ESG data raises concerns over the quality of the data; moreover, the data provided across companies has been inconsistent. There have been some standardization efforts by organizations, however, none of these reporting standards has been universally adopted. In addition, active managers have been under pressure from index funds due to their low costs and their general outperformance. For active managers, ESG strategies have been a bright spot in terms of new fund launches and new money inflows. The pace at which ESG strategies have been launched is drawing concern over exaggerated representation of how well investments are aligned with sustainable goals, a term called “greenwashing”. Finally, it is difficult to combine the different metrics in some quantitative way. For example, consider the environmental impact of electric vehicles. How does one weight the inputs of energy and rare earth minerals used in producing and operating electric vehicles versus its outputs of zero emissions from driving the cars? Similarly, social factors depend on social norms and the scale of ESG ratings also differs by data provider.

The current academic literature leaves us with a healthy dose of skepticism and there is much more that remains to be explored. Firms need to commit more resources to ESG issues and there is optimism that practitioners and academics will come together to address the pressing ESG issues that face our society today and for years to come. The marketplace itself is becoming more-and-more ESG simply as a capitalist response towards protecting and promoting company share prices. One might argue that an index such as the S&P 500 is today essentially an ESG index. At Schultz Collins, we offer a small stable of funds with varying levels of commitment to ESG values. Our due diligence process for evaluating investment alternatives requires that funds have at least a 5-year track record and with every passing year, more funds are meeting this base requirement. Over the past 5 years, we would conclude that your portfolio has likely moved to a stronger ESG tilt by virtue of the marketplace’s shift to become more ESG-focused.



Source: https://blogs.cfainstitute.org/investor/2019/09/03/esg-investing-can-you-have-your-cake-and-eat-it-too/

Should you have questions or comments, we would like to hear from you.

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