ETFs are Socially Irresponsible

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ETF managers tout their low fees, but what if those low fees are justified? Instead of being a feature, what if low fees are an accurate representation of the value provided by the product? Consumers make value judgments all of the time, paying more for healthy foods than unhealthy foods or paying more for electric cars than comparable gasoline-powered autos. ETFs create some social problems, making them less worthwhile products to the growing ranks of socially conscious investors.

KEY TAKEAWAYS

1. **Social consciousness is something most easily seen by its absence.**
2. **Consumers pay more for ESG affirmative products and services.**
3. **Enterprises that enhance their communities and constituencies are worth more.**
4. **Passives are not socially responsible investments and their fees should be low as a result.**

Social Consciousness: You Notice Its Absence

Does the degree of social responsibility have a significant impact on what a business's product is worth? Does citizenship matter? Answers to these questions have proven difficult, in part, due to a lack of agreement on what social responsibility entails. Is there value in discouraging longstanding anathema to Socially Responsible Investing (SRI), liquor, tobacco, and weapons? Tax and regulatory regimes suggest so. However, does that constitute social responsibility? Many social investors think not. Instead, some look to measure a firm's interest in the health of its communities and the benefit to broad constituencies (customers, employees, investors).

Two different attempts to measure this interest are called Corporate Social Responsibility (CSR) and Creating Shared Value (CSV). Extending upon those concepts, Environmental, Social, and Governance (ESG) approaches to social responsibility track particular social deliverables in more depth. With at least four ways of measuring social responsibility, a uniform view is lacking. Nevertheless, there is broad agreement that failures in corporate citizenship reduce the value of an enterprise. A quote from E.L. Konigsburg fits the situation, "You must know of something's existence, before you can notice its absence."

Recent examples indicate that our society expects enterprises to deliver safety, fidelity, conservation, and diversity as parts of the value of their product or service. Presence of unsafe quantities of cancer causing chemicals in laminated flooring products changed social value perceptions of Lumber Liquidators. In the services area, Sea World attendance fell sharply after a documentary showing danger to humans from their killer whale breeding and training practices. Evidence that bankers fabricated bank accounts, moved money from clients into those accounts, and charged fees to fix resultant account issues, harmed Wells Fargo's reputation for fidelity. Finally, reports that minorities represent only 3% of Twitter's workforce may be discouraging other companies from partnering with the firm. All four of these companies have demonstrated an absence of social responsibility, and it has impacted their business conditions and the value of their intellectual assets.

If products and firms can be repudiated due to social failings, can entire industries lacking societal responsibility be castaway as well? Yes. The coal industry's inability to counter its environmental shortcomings has resulted in a significant shift in power generation away from coal and into natural gas and renewables. Soft drink and fast food industries stand out today as businesses hampered by frequent press attention to the social problem of obesity which these industries facilitate. Like the coal, soft drinks, and fast food industries, the ETF industry fosters social problems. The industry adds a layer of risk for an investor in its products (see previous paper), it increases correlation of assets, it inhibits price discovery in the stock and bond markets, and it retards "the overall growth rate of the economy due to a decline in the efficiency of capital allocation" (Bernstein). Seeing customer safety and financial market fidelity issues, JAG believes investing using ETFs to be a socially irresponsible practice. We think thoughtful people applying either SRI, CSR, CSV, or ESG criterion would agree.

ETF Fees Should Be Low

The siren song of the ETF industry is that ETF fees are low. JAG has argued in previous white papers that ETFs have inherent risks (counterparty risk, high failure rates, volatility). The presence of these risks may necessitate low relative fees to compensate investors for that higher risk. Further influencing fees downward, products and services absent social responsibility are worth less. ETFs make the stock and bond markets less efficient, and thereby do collateral damage to capital allocation, a social negative. Since ETFs have high risk and low social utility, the value provided is low, therefore, the fees should be low. Low fees are not a feature of ETF investing, they are a symptom of social stigma.

Socially Additive Enterprises Are Worth More

While consumers distinguish between products that are socially valuable and those that are not, investors also seem to place a higher value on companies performing a perceived social good. Logically, companies with high SRI/CSR/CSV scores tend to be less wasteful, have lower employee turnover, and have greater customer loyalty. Hasbro, #3 in *CR Magazine*'s Best Corporate Citizen's List, has a higher margin and a higher ROE than toy rival Mattel. Aside from exhibited financial performance, investors seem to place higher valuations on companies contributing to social progress. The three highest ranked CSR companies (GOOGL, MSFT, DIS) sell at a combined average 60% premium to the S&P 500 price-to-sales ratio.

At an industry level, organic grocers are priced at a substantial premium to mainline grocers, and solar companies are priced 2-3 times the multiples of fossil fuel companies. We suggest that the valuation advantage for socially responsible industry groups applies to asset managers as well. Traditional asset managers, tend to allocate capital to perceived areas of return opportunity, and thereby contribute to efficient capital investment and market function. These businesses sell at a substantial premium to managers with ETFs as a large part of their product mix. The three large, public ETF managers trade near 1.5X book value, while the three largest pure play asset managers are valued at over 3.5X book value. This may come as a surprise to some, but the pure play asset managers have better records of long term book value growth as well. We believe that managers making active investment decisions serve a social good. In today's stock market, investors willingly pay more for active managers than ETF managers. We think consumers buying investment products would be justified in doing the same.

Socially Productive Assets Perform Better

Consumers and investors have an unfavorable response to enterprises failing to fulfill social responsibilities. Building upon the anecdotes above, broader public company statistics show the same thing. Two decades of research show that investing in companies pursuing social good is at least a non-negative. Academic studies from Harvard, RBC Global, and New Amsterdam Partners, prove that investment performance benefits if companies with poor CSR records are eliminated from investment consideration. A February *Wall Street Journal* report reveals "companies with high eco-efficiency—that generate the least waste relative to the value of their products and services—outperformed." There are examples of socially responsible funds underperforming the market as well, but, at very least, the research indicates that when it comes to comparing socially responsible activities to standard investment options, "the performance is about the same'" (Meir Statman). JAG's own look at near term data supports socially productive asset performance. Using Bloomberg's ESG Disclosure score to measure willingness to at least disclose environmental and social exposures, JAG found that companies with top quartile ESG Disclosure scores have outperformed companies in the bottom quartile of the ETF Disclosure rankings by 530 basis points year-to-date as of September 2016. If social conscience oriented investments perform at least as well as standard investment options, and among these options, ETFs have known social problems, shouldn't investors pay less for ETF-based market exposure? We think a healthy discount is warranted.

What about socially responsible ETFs? Twenty-three ETFs with some social features currently trade. Fortunately, sizes and fees give us simple ways to deal with the social ETF question. To our calculations, only two existing socially responsible ETFs are profitable: DSI and KLD, both from Blackrock. These two ETFs have roughly $1.1 billion of the $1.6 billion in assets in the socially-responsible ETF group. The expense ratio on both funds is 50 basis points, not dissimilar from the fees charged by active managers of socially-responsible assets. Instead of wading-through the complexities of investing in a socially targeted product within a socially negative management company, given the fee relative parity, we do not see a negative to choosing an active manager, like JAG, for socially responsible investments. The "greek" section below will expand on this point.

In Greek Terms

Investors often measure the value of an asset management service in terms of beta and alpha. Beta measures the degree of exposure to the market, and alpha measures the skill of the manager in selecting investments. Social value would be contained within the alpha measurement. The great majority of domestic ETFs (we looked at 905 of them) have a beta near 1.0, meaning that they replicate the market. The average ETF management fee is 39 basis points. However, scale really matters here, as the top 25 (by assets) 1.0 beta ETFs have an average management fee of 17 basis points. Those fees have been dropping, and there is some industry press suggesting, as we would assert due to the social issues, that those fees will trend toward zero over time. For any ETF attempting to replicate a passive index, a management fee greater than 25 basis points is hard to justify in our opinion. By our calculations, fees for 77% of the domestic ETFs exceed that level today. Regarding alpha, ETF investors are currently paying an average 38 basis point premium to the beta-based fee for ETFs producing alpha. Current investors seem to think that 35-40 basis points is the value of capital direction and price discovery. We suggest using that threshold as a bearing to whether ETF fees are low enough. Due to the social issues we have described and additionally guided by observable prices, we think ETF management fees should be 35-40 basis points below comparable active management fees, and no higher than 25 basis points.

Conclusion

ETF managers have low fees relative to active managers; however, those fees should be low. ETFs are not socially responsible investment vehicles. Consumers frequently pay more for socially responsible products and shun businesses lacking those characteristics. In the investment world, socially responsible enterprises merit higher values, while socially responsible portfolios perform and provide benefit exogenous to their performance. The ETF feature of "low cost to the consumer" is not a plus, when those low fees merely reflect poor citizenship. Consumers SHOULD pay less for ETF products. The only question is how much less. Our analysis suggests it's a long way down from current average levels.

Generational Change Prompts SRI to ESG Enhancement

We believe this social responsibility topic is particularly timely as the industry is beginning to see a generational change in investment inflows. Millennials have broadened the audience for corporate social responsibility. For 70 years, JAG Capital Management has invested in socially responsible (SRI) businesses, and we welcome the enthusiasm for that practice among millennial investors. What used to be a small audience of investors with social priorities, has now changed to consumers who seek social impact with purchases, including investments. "Fifty-five percent of global online consumers…say they are willing to pay more for products and services provided by companies that are committed to positive social and environmental impact" (Nielsen). For millennial investors, "53 percent [say] they made investment decisions based on social factors" (Spectrem) about 10 points higher than other generations. Young consumers see value in institutions making a positive social impact. The ETF industry is one that does not fit that criteria.

Building upon its SRI history, JAG Capital Management is enhancing its asset management approach to incorporate ESG principles. Our updated product offering utilizes MSCI ESG scores along with JAG's research capabilities. We extol companies making socially additive products, and we invest in firms demonstrating that their commitments to waste reduction, human capital development, product safety, and business ethics produce superior financial performance. ESG research insights, such as the social irresponsibility of passive investments, will be implemented within the investment strategy. We anticipate JAG ESG portfolio strategies will be available to investors in the fourth quarter of 2016.

About JAG

JAG Capital Management is an independent, 100% employee-owned registered investment advisor headquartered in St. Louis, Missouri. The firm provides portfolio management services for institutions, individuals, investment advisory firms and corporations. In addition to managing the JAG Large Cap Growth mutual fund, equity and fixed income separate accounts are also offered.

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