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CAPITAL MANAGEMENT LLC

# Passive Activism. What the What?


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Social investing is fraught with actual and potential challenges. Socially-responsible investors sometimes find that their social goals conflict with their targeted investment performance or portfolio diversification guidelines. Investors often rely upon biased social metric scores provided by third-party firms. All of this being the case, we think the rise of passive social investment vehicles could present the most significant stumbling block to social investors. Can investors hope to achieve a positive social impact through utilizing passive investments? We think not, for several reasons:

- **>> Social investment scoring systems have a large cap bias.**
- **>> Correlations between social indices and broad market indices are high.**
- **>> The performance record of social indices is largely not good.**
- **>> Passive activism is an oxymoron.**

## Scoring Bias

Overlap between most social index stock holdings and the largest stocks in the major indices is high. One criticism of social scoring methods produced by Morningstar and MSCI is that they favor large companies. These large companies tend to have larger human resource and public relations departments that can manage social initiatives and champion social efforts. Similarly, larger corporations have more resources available to highlight their progress on social goals. Due to these facts, large companies are over-represented among the highest sustainability scores.

JAG assigns singular, numerical ESG scores to a large universe of common stocks using MSCI Environmental, Social, and Governmental ratings. We find that the average large cap stock (> $6 billion market cap) score is 0.61 (1 is the highest possible score), while the average small cap ESG score is 0.46. In a separate analysis, JAG also finds a material difference (nearly 2 points in a 10 point scale) in Environmental scores when we compare the top decile stocks by market cap and the bottom decile stocks by market cap. The result is a meaningful large cap bias to social scores, which leads to a noticeable tilt toward big companies within social indices. In effect, social investors who utilize passive investment vehicles are making a bet on large companies. Given the fact that it is more difficult and expensive to impact the behavior of very large corporations, we think passive social investments may work against many investors' intentions to have a positive societal impact.

## Index Aware

Not only do social indices skew large, they tend to hold large cap stocks roughly in proportion with weightings in the broad market indices. A September 2017 study by Balcilar, Demirer, and Gupta shows the correlation between the Dow Jones Sustainabilty indices and the Dow Jones conventional indices to be 0.987 in the Americas. Despite the close correlation, the authors conclude that diversification benefits, however de minimus, are possible by integrating social indices. We would observe that such a tight correlation reveals little difference (98.7% alignment) between the social indices and the broad markets. Another way to measure index alignment is "active share." Active share figures indicate the percentage of holdings in a portfolio are NOT aligned with a benchmark. Close alignment generates a low active share score, whereas active shares above 80 are generally considered favorable for those attempting to achieve excess return relative to the indices. With that in mind, we note that compared to the S&P 500 Index, active shares of the MSCI Low Carbon Target ETF and Workplace Equality ETF are 52 and 62, respectively. As such, both ETF's have a lot in common with the S&P 500. By failing to differentiate their holdings from broad market benchmarks, passively-oriented social investors may be diminishing their potential to make a positive impact.

## Index Performance

Critics of social investing would say that in trying to achieve more than one purpose, investment performance and social impact, investors are unlikely to be successful at either. As evidence, these critics might point to the performance of socially responsible indices versus the broader market benchmarks. For example, the most prominent (by assets) social index is the MSCI KLD 400 Social ETF and that index has underperformed the S&P 500 on three and five year bases.

**Performance Relative to *SPY**

| Ticker | Name | 1 YEAR 4/13/2017-4/13/2018 | 3 YEARS 4/13/2015-4/13/2018 | 5 YEARS 4/13/2013-4/13/2018 |
|---|---|---|---|---|
| AASGITR | Dow Jones Sustainability U.S., Composite Total Return Index | 2.1% | 1.1% | -0.3% |
| NCV400U | MSCI USA Catholic Values Net Return Index | 2.0% | -0.1% | -0.3% |
| SUSA | iShares MSCI US ESG Select (SUSA) | 0.2% | -0.1% | -0.7% |
| M1USLSI | MSCI USA Large Cap SRI Net Total Return USD Index | 3.1% | -0.3% | -1.2% |
| SPXCVUN | S&P 500 Catholic Values Net Tot Ret Index | 0.0% | -0.3% | 0.0% |
| SPXESREN | S&P 500 Env. & Socially Responsible Exclusion Net Total Return Index | -0.3% | -0.3% | 0.0% |
| SPXESRN | S&P 500 Environmental & Socially Responsible Net Total Return Index | -0.2% | -0.6% | -0.4% |
| DSI | iShares MSCI KLD 400 Social ETF (DSI) | 0.1% | -0.8% | -0.7% |
| SPXESGUN | S&P 500 ESG Factor Weighted Net Total Return Index | 0.0% | -1.2% | 0.0% |
| EQLT | Workplace Equality ETF (EQLT) | -2.0% | -1.3% | |
| NUSSLMU | MSCI USA ESG Leaders Net Return Index | -0.5% | -1.4% | -1.5% |
| NUSSAU | MSCI USA Broad ESG Leaders Leaders Net Return Index | -0.5% | -1.4% | -1.4% |
| KLD400 | MSCI KLD 400 Social Net Return Index | -1.2% | -2.1% | -2.0% |
| CRBN | iShares MSCI Low Carbon Target ETF (CRBN) | -0.3% | -2.3% | |
| LOWC | SPDR MSCI Low Carbon Target ETF (LOWC) | -0.6% | -2.6% | |
| M1CXBLW | MSCI EAFE ESG FOCUS Net Total Return USD Index | 1.6% | -4.5% | -5.8% |
| QCLN | First Trust Clean Edge Green Energy ETF (QCLN) | 4.9% | -7.7% | -0.5% |

* SPDR S&P 500 ETF, a market-cap-weighted index of US large and midcap stocks

Source: Bloomberg, MSCI

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All except one of the social indices trailed the S&P 500 on a 3 year basis.  Five year data is less complete due to more recent inception dates.   However, that data reveals two social indices matching S&P 500 performance, none beating the benchmark and most trailing.  While the relative performance of most social strategies is suboptimal, one methodology does stand out among the group, Catholic Values. Catholic-based strategies often exclude companies engaged in the production of offensive weapons, tobacco, and abortifacients.  Avoiding stocks in those industries has boosted overall investment performance in recent years.  The US has not had a major conflict in that time period, and tobacco use is steadily declining.  Social decisions aligned with business conditions in those cases.  However, abortifacient use has increased, leaving the social and business conditions unaligned.  Stock performance is thought to mirror corporate financial performance over time, and the financial performance of the Catholic Values exclusions was a net neutral.


Managers following Catholic values strategies are frequently considered to be Socially Responsible Investors (SRI).  While many of the vast social strategies are new ones, SRI investing has a long history (possibly due to its performance results).  JAG Capital Management has been an active Socially-Responsible investor for decades.

## Oxymoron

The essential purpose of social investing is for the investor to have an impact on one or more social goods. Investors do this by either channeling capital to support that good or by using voting rights and shareholder platforms to influence the social choices of company managements.  We wonder… if social investors are choosing to be active in their advocacy, why would some choose to be passive in their implementation of that social choice?  ETF's are popular investment vehicles in social investing as they are for other asset classes.  We've already indicated that passive social indices have a large cap bias and a high correlation to common broad market indices.  Passive social indices also rebalance infrequently on a set schedule.  That method puts social investors in a position to be reactive to changes in corporate social policy, rather than proactive advocates.

Active managers have the ability to compensate for the large cap bias of the social scoring systems.  An active manager can reduce correlation to both the social and broad indices by selecting and weighting individual investments, thereby producing active share.  Finally, an active manager can shift assets to influence social change, vote proxies in favor of social goals, and utilize shareholder forums to promote social ideas.  Performance and impact are both lost with most passive social investment choices.

## Conclusion

The track record of performance from social investing indices is generally not positive.  Social scoring systems are biased to large companies, and social indices generally fail to produce diversification relative to broad indices.  Impact depends upon active management of capital and active enforcement of shareholder rights.  Discretion, diversification, and advocacy demand an active investment management solution.   JAG Capital Management has a long history of offering such solutions.

## 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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