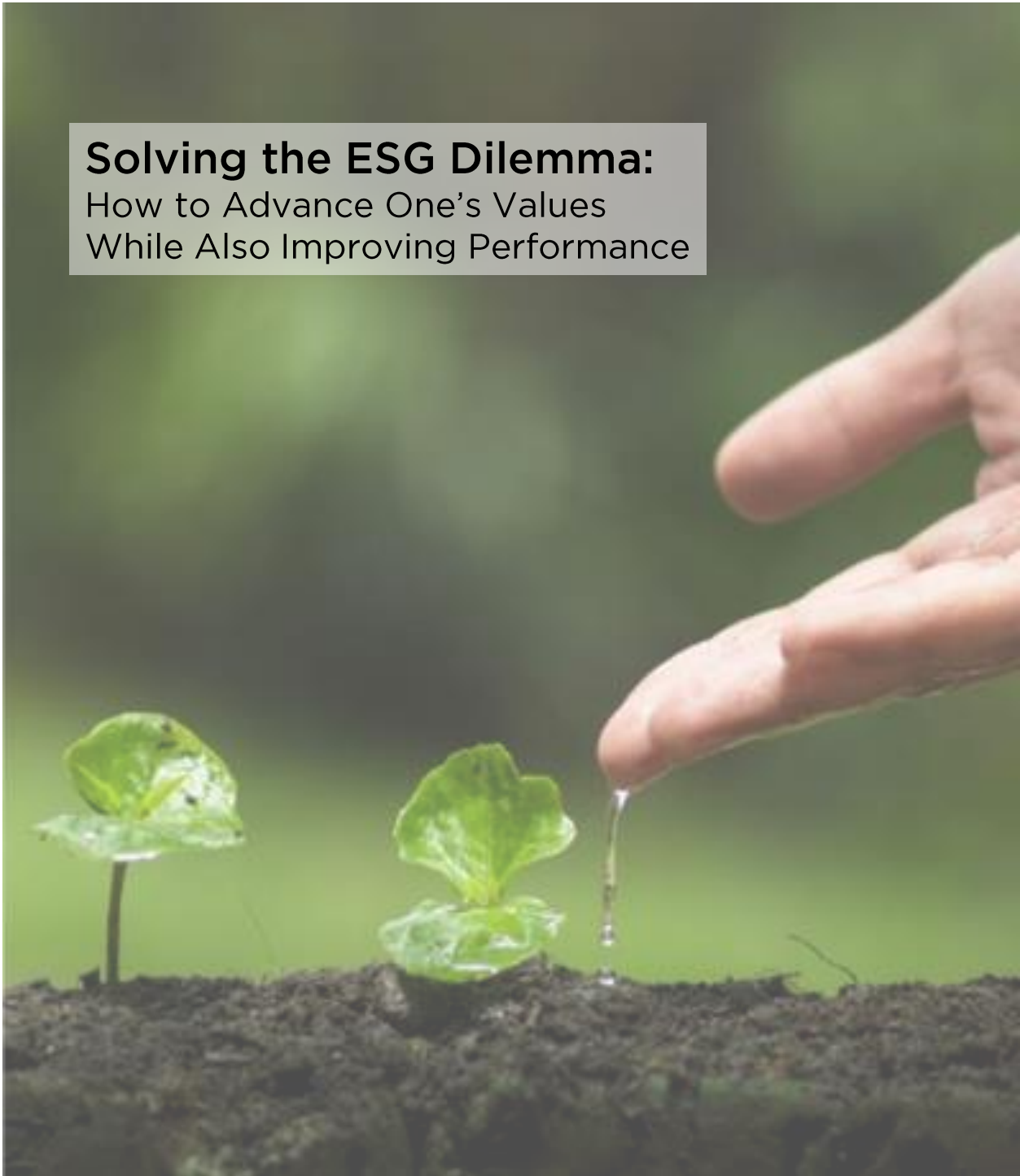


Solving the ESG Dilemma: How to Advance One's Values While Also Improving Performance



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Preface

The recent proliferation of ESG funds reflects a surge of interest among investors to align their investment portfolios with their values.

While the impetus for the ESG movement signifies a meaningful change in investor behavior, we observe that ESG investment returns are generally disappointing. That is, **most ESG funds underperform the market and reflect the same systemic risks borne by passive equity investors.**

We see the potential for innovations that make truly material improvements in ESG investment performance. And if so, these concepts may help address today's ESG dilemma: *how to advance one's values while also improving the mission of performance?*

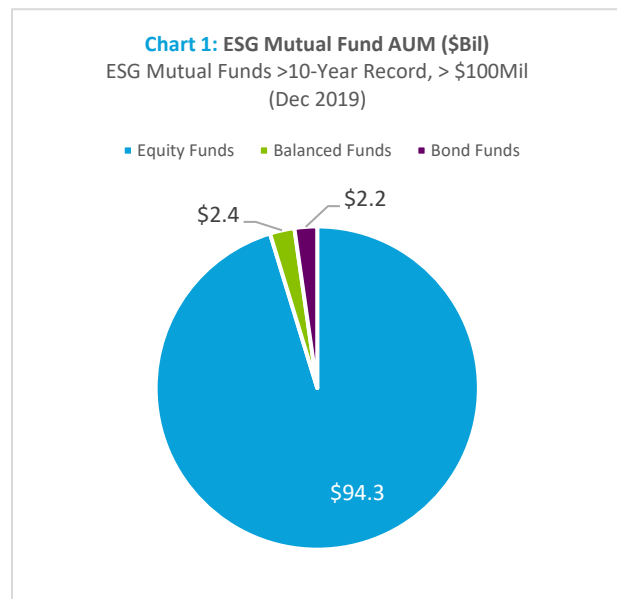
In particular, we believe ESG funds could benefit from the following three design and management techniques:

1. Integration of timely and broad ESG datasets
2. Dynamic stock selection and weighting using machine learning techniques
3. Use of orthogonal strategies to mitigate market risk and enhance performance

Sample Fund Universe for Study

To assess ESG fund performance we started with the largest ESG mutual funds. We then screened for those funds¹ with at least 10-year track records and a minimum of \$100 Mil in AUM. This yielded a group of 62 funds representing \$99 Bil in assets. This equates to 72% of Morningstar's estimated \$137.3 Bil in total sustainable mutual fund and ETF assets at the end of 2019.²

Not surprisingly, the first observation from our sample is that ESG fund assets are almost entirely concentrated within Equity funds as opposed to Balanced or Bond funds (Chart 1). In fact, Equity funds represent 95% of all ESG fund assets in our sample.



¹ Source: eVestment and Morningstar

² "Money Moving into Environmental Funds Shatters Previous Record," CNBC. Jan 14, 2020.

ESG Funds Have Generally Underperformed the Market

Using our ESG universe, we observe that the majority of funds have underperformed the wider market over the last decade. (Chart 1 and Table 2). The market is represented here by the S&P 500 TR Index³ which one can consider to be investable as shown given its slim +4bps/annum performance differential with the Vanguard S&P 500 ETF (VOO).

There could be multiple performance reasons at play, and probably in combination. ESG funds likely differ from the index, such as sector weighting differences and resulting dividend availability. The S&P 500 may not be the optimal comparison index for some. For example, variations among funds could include: large caps vs. small caps, developed vs. emerging markets, or concentrated vs. diversified portfolios. Even the “ESG-ness” of funds likely varies, whether in the integration depth of their process or rigidity of their ESG screening criteria. Of course, fees will also impose a material difference between our index and the funds shown too.

Our goal is not to settle the question of ESG alpha or offer definitive explanations for each of the funds in our sample.

We simply observe that approximately 70% of all sustainable mutual fund and ETF assets represented by the 62 largest funds underperformed the broader market over the last decade - sometimes by a meaningful margin. And whatever the cause, ESG funds do not appear to differ markedly from all other actively managed funds. According to the most recent Dow Jones SPIVA[®] U.S. Scorecard, 96.57% of U.S. large cap core funds were also outperformed by the S&P 500 Index over the last 10-year period.⁴

Investor expectations will vary, and for some, this outcome is an acceptable one. Near-market performance by some funds may be an acceptable trade-off in investors' pursuit of desired social or environmental change. For others, this finding may disappoint. They may see the inherent impairment of their mission if they find themselves on the lower end of this performance spectrum.

We also know that examining performance in the absence of risk misses a primary concern. Investors who pursue ESG are not immune to the risks they are taking. We will examine this next.

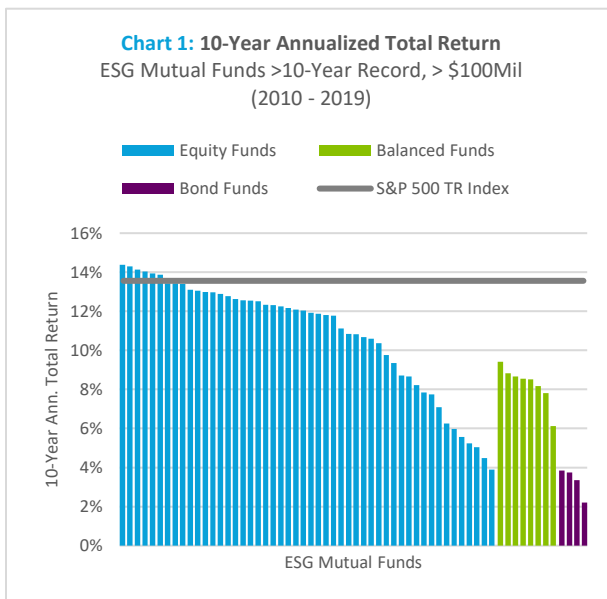


Table 2: 10-Year Annualized Total Return
(2010 – 2019)

	Median 10-Year Annualized Total Return
S&P TR 500 Index	13.56%
Equity ESG Funds Only	11.98%
All ESG Funds	10.84%

³ Source: Bloomberg. The S&P 500 Total Return Index is included for comparative passive equity investment performance. It is a U.S. stock market index based on the market capitalizations of 500 large company stocks chosen for market size, liquidity and industry grouping, among other factors. Index constituents and their weightings are determined by S&P Dow Jones Indices. It tracks the underlying price index and reinvests dividend income in the overall index, not in the specific stock paying the dividend.

⁴ SPIVA U.S. Scorecard, Mid-Year 2019. Page 4. November 13, 2019.

ESG Funds, How Much Risk Reduction?

Company- and Industry-Specific Risk

The case for ESG mediated risk mitigation is based on two conjectures. The first is that one can diminish idiosyncratic risk (i.e., company-specific risk) by excluding companies with higher future risk potential relative to their industry group peers. The second is that certain industries, such as oil and gas, have higher inherent industry-specific risks relative to others. Flare ups for both risks, however, will occur episodically and perhaps infrequently, making it challenging to objectively test for incidences of company/industry-specific mitigation among a wide collection of funds.

Systemic Risk

Rather than seek to answer the difficult idiosyncratic mitigation premise, we chose instead to examine the more material systemic risk question by focusing on specific periods of acute economic contraction.

Do ESG investors bear the same risks as ordinary passive investors, or do ESG portfolios have additional protections to preserve performance when investors most need it? After all, these events are unquestionably material, and any mitigating properties during crisis periods may even outweigh occasional idiosyncratic controversy risks.

To find out, we chose three periods for our analysis. For our bear market period we chose the peak-to-trough drawdown during the Global Financial Crisis from October 2007 to February 2009. For our market correction period we chose Q4 2018, memorable for its sudden volatility and the swift 14% drop in the S&P 500 at the close of 2018. Lastly, we also examined the still-unfolding COVID-19 pandemic period of Q1 2020.

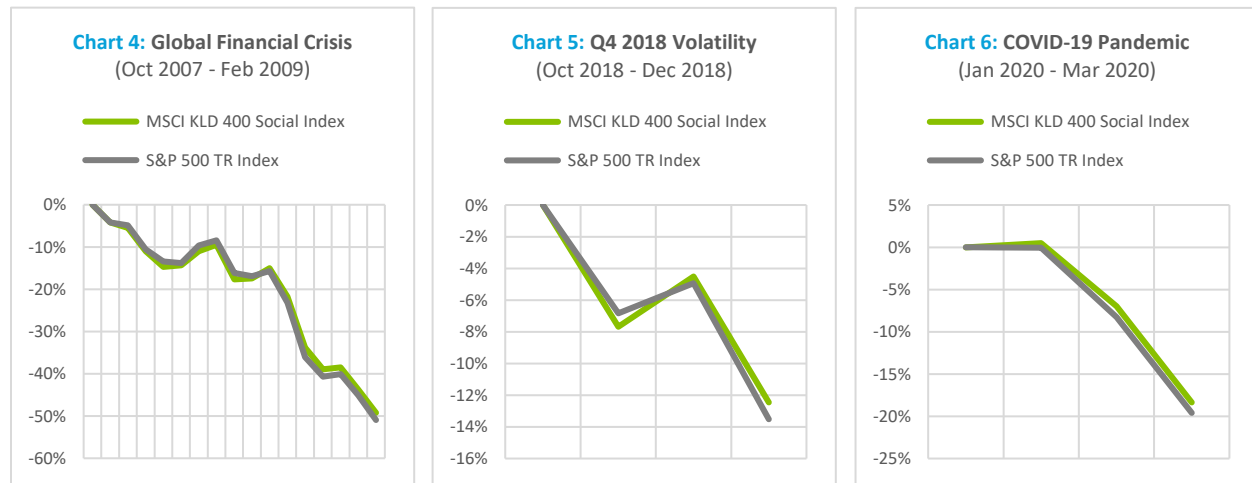
We selected the MSCI KLD 400 Social Index⁵ as our proxy for general ESG fund performance. The KLD 400 is the most prominent U.S. equities-based ESG index that existed back to the GFC in 2007, and its performance and construction make it well suited for our comparison. The KLD 400 and the S&P 500 share similar volatilities (Table 3) and it is comprised of 400 North American companies that meet high ESG standards.

Table 3: 10-Year Performance Statistics
(2010 – 2019)

	MSCI KLD 400 Social Index	S&P 500 TR Index
Ann. Total Return	12.55%	13.56%
Ann. Volatility	12.44%	12.46%
Return-to-Volatility	1.01	1.09

Results appear in the following three charts (Charts 4 - 6) and we can see that the MSCI KLD 400 Social Index mirrored the S&P 500 downward during all three events but with a slight improvement in performance. And while any improvement is certainly noteworthy, the much clearer takeaway from these charts is that ESG investors shouldered virtually the same market risk as passive equity investors. **Idiosyncratic risk mitigation is simply overpowered by systemic market risk during crises and corrections alike.**

⁵ Source: eVestment. The MSCI KLD 400 Social Index is included as a proxy for general ESG fund performance. From Sep 2010 to the present the index includes reinvested gross dividends, i.e., reinvested with no assumed withholding taxes. Prior to Sep 2010 the index includes net dividends based on the maximum withholding tax rate applicable to institutional investors.



Summary

ESG funds provide an important means for investors to align their portfolios with their values. Opinions differ on whether ESG contributes to outperformance, or is the source of underperformance. While we are unable to settle this debate here, we can offer observations using the actual performance of the largest ESG funds available today. And upon examination we find that in general **the average ESG investor has underperformed the market while shouldering the same systemic risks borne by passive equity investors.**

And this is not necessarily a bad outcome. Near-market performance by a handful of funds may be satisfactory for some. Moreover, it is likely that most ESG investors aspire only for modest idiosyncratic risk reduction.

But do near-market returns and unmitigated market risk represent the apex of achievable ESG performance? Can ESG investors who view their own governance responsibilities to achieve better returns and lower risks with assets under their charge do better?

We think they can.

Welton's Innovative Approach to Improving the ESG Investor Experience

We believe opportunities exist to improve ESG investors' experience. As one moves beyond a long-only, equity-centric ESG model, we believe sophisticated techniques commonly used within hedge funds and quantitative investment firms may be beneficial. We will briefly introduce three here.

Integration of timely and broad ESG datasets

ESG data represents a potential source of both alpha and risk mitigation. As such, it may be best integrated in a timely, even daily, manner. Moreover, because ESG risk can materialize swiftly, such as developing controversy risk, technological tools such as online data scraping, natural language processing and AI are particularly useful. Another consideration, particularly for quantitative firms like Welton, is the importance of identifying ESG data sources with long histories (15-20 years) in order to identify robust indicators tested across market cycles. Finally,

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combining additional ESG datasets is yet another step to build greater ESG data breadth and depth. Big data challenges such as these are particularly well suited to firms with a quantitative and technological base of expertise.

Dynamic stock selection and weighting using machine learning techniques

High quality data can be assessed within an actively managed portfolio that harnesses machine learning-based approaches for signaling, forecasting, and modulating exposure across varying market conditions. Return forecasts constructed using statistical arbitrage techniques has the potential to dynamically lean exposure toward certain securities and away from others. While market cap portfolio weighting is common, alternative techniques taking risk exposures into account have the potential to better manage portfolio volatility. Systematized processes are capable of analyzing the myriad variables required, are reliably repeatable, and lend themselves to continuous improvement because all decisions and outcomes are rigorously tracked for further analysis.

Use of orthogonal strategies to mitigate market risk and enhance performance

As described earlier, today's long-only, equity-only ESG funds behave predictably – *they behave like the wider market*. The addition of orthogonal strategies to the mix, however, has the potential to **elevate investor experience away from market risk, and beyond market-only performance**.

How?

Orthogonal strategies such as trend following combine two highly complementary traits to help address the ESG performance dilemma: a multi-decade history of non-correlation to the broader equity markets, and a positive return expectation over reasonable holding periods. When combined with an ESG equity portfolio, the resulting portfolio has the potential for both diminished risk and elevated annualized returns.

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We at Welton are experienced building portfolios that draw on all of the techniques described to enhance the ESG experience for our investors. If you care to learn more, we would be glad to talk. Please contact us.

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