First Affirmative
a FolioFinancial company

Affirmative Impact
June 2020

# Sustainable and Impact Investing in the New World

Many pundits discuss the "New Normal" that will arise when the pandemic ends and the economy recovers. For many in the U.S. and for most in the developing world, the "Old Normal" was not that great. The "Next Normal" will need to provide more equitable and more sustainable living conditions for a much larger portion of the population.

As I near the end of my 33rd year at First Affirmative Financial Network, I reflect on what I have experienced in, and hopefully have learned from, the financial marketplace. The "Crash of 1987." The "Asian Contagion." September 11, 2001. The "Dot-Com Bubble and Burst." "The Great Recession." "The Flash Crash." Except for 9-11, these market experiences were all the result of government, economic, or market decisions or conditions, frequently combined with some type of "financial engineering."

These are the words we are never supposed to say: "This time it's different." The 2020 triple whammy of COVID pandemic, social unrest, and the growing menace of Climate Change will change many aspects of the investment landscape and economic behavior, in some cases for a temporary timeframe, and in some cases almost certainly permanently.

At the time that the long-term health of our economy is compromised by Environmental, Social and Governance risks, the use of ESG research to evaluate investments based on these very factors has moved to the forefront of the investment conversation. The Sustainable, Responsible Impact Investing community, with leadership from First Affirmative and our annual industry event, the SRI Conference, were pioneers of the concept that corporate decisions relating to race, gender, product safety, environmental stewardship, resource conservation, and other values-related areas are strong determinants of investment performance and risk, as well as economic and societal well-being. Indeed, it is ironic that our previously scorned point of view is now being embraced, via the new ESG language, by almost every part of the investment industry.

Even more importantly, the current market has provided abundant evidence that utilizing ESG research can work to improve performance and reduce risk. While past performance cannot guarantee future results, we are confident that business models of responsible companies are often based on a more solid foundation which also reflects better valuations.

A quick look at the landscape. The 10-year Treasury Bond yields 0.71%, not far from its historic low. The 30-year Treasury Bond yields 1.45%, less than the dividend yield on the S&P 500 of 1.96%. A substantial amount of international debt is priced to yield less than zero. By most valuation metrics, the stock market is richly valued, as the economy slides into a recession plagued by historic unemployment rates, with recovery dependent on a yet unfound vaccine.

The impact of the pandemic and social justice concerns is moving so fast that it is impossible for ESG researchers to keep up. The expectations for an acceptable level of gender and racial diversity in corporate management and C-Suites will have to change radically. The view of the sustainability of certain economic sectors will also have to be totally reconsidered. For example:

- Real Estate. Shopping malls and big box stores were already dying due to the Internet. Add to that the question of whether half of employees will ever return to office cubicles in high-rise buildings in downtown locations. How will downtown businesses like restaurants and stores survive if people don't return downtown to work? As people have lost their jobs, they have stopped paying their mortgages or their rent. Once eviction protections expire, the homeless population is expected to increase dramatically.

- Mortgage processing. These firms collect mortgage payments and then break them into constituent parts, forwarding payments to investors, governments and insurance companies. When people stop paying mortgages, these payments must still be made.

- Travel & Leisure. Airlines anticipate that it will be two years at least before they can return to pre-COVID volumes. Hotels, theme parks and cruise lines have been devastated and will, at best, have to operate under incredible mountains of debt.

- Speaking of debt, pressures to keep interest rates low, led by trillions in additional federal debt, but also by lost revenues at state and municipal levels added to corporate losses, will affect retirees, banks, insurance companies, investment management firms and carbon energy extraction firms. When interest rates do finally rise, they will leverage the size of the national debt, increasing annual deficits dramatically.

- Health Care. Will COVID be the trigger that changes the approach to for-profit healthcare and health insurance in the U.S.? The pandemic has exposed the revenue models of most hospitals, and they rely far more on "elective" procedures than most realize. To date, approximately 27 million Americans have lost job-based health insurance. As emergency rooms process more and more people with no ability to pay, hospitals lose even more money.

- Service Industries. The pandemic has totally changed the definition of "essential workers." Grocery store clerks, truck drivers, warehouse staff, health care workers and other relatively low paid employees are on the front lines every day, continuing to work and being at risk for infection. These employees will not likely continue to tolerate near minimum wage compensation with no health care benefits after the hazards of COVID 19 are mitigated. How long will it be before millions of restaurant employees go back to work again?

- For-profit prisons, predatory lending, for-profit colleges. All industries that systematically take advantage of the poorest segments of our population should be excluded from any responsible investment portfolio.

- Agribusiness and Animal Products. The impact of the pandemic has increased the awareness of just how fragile our agriculture system has become. Food deserts are on the rise – endangering some of our most vulnerable populations. Major upheavals in U.S. cattle markets has increased attention on the growing gap between high beef prices and low cattle prices. We have discovered that the supply chain is far more fragile than almost anyone knew, with only three pork processing plants handling the lion's share of this product for the entire country plus export to foreign markets. Many farmers have lost their traditional markets due to COVID-19-related school, university, restaurant and hotel closures. While the current environment presents great opportunities for change, the pain our population is currently experiencing runs deep. Alternatives to traditional protein sources are likely to become more attractive.

- **Carbon Energy.** We recently saw the futures price for crude oil drop briefly to NEGATIVE $40 per barrel. While an aberration, it is true that very few energy companies can make money when oil is below $40 per barrel, especially shale and tar sands energy. Coal is already non-economic in almost all conditions. While some carbon energy companies maintain healthy ESG ratings, most responsibly invested portfolios either underweight this segment or avoid it entirely.

- **International Trade.** So far, I have only spoken about conditions in the United States. Well diversified investment portfolios have always held positions in global or foreign corporations. While the infection rate in the U.S. remains the greatest in the world, some other countries, such as Brazil are rapidly catching up. Oxfam projects that, worldwide, COVID could push a half billion people into poverty. It is likely that trade tensions, already high with China, could worsen depending on where protective clothing and devices, and eventually vaccines are manufactured versus where they are needed and what governments will do to obtain them. At the same time, we have already forgotten that large portions of Australia were on fire only a few months ago and that extreme drought conditions plague large portions of Africa and Asia. As the pandemic distracts attention, environmental protections are being rolled back around the world.

- **Police Departments versus the rest of the municipal budget.** Clearly, police departments will be getting a smaller share of the municipal pie. In particular the militarization of police equipment will most likely be reduced. On the other hand, fire, emergency services, mental health and other portions of city government will probably see increased employment and resources for contracting other community services.

- **A small silver lining.** With much of the world locked down, we have seen proof of the resilience of the world around us. People in India can see the top of Mount Everest for the first time in 30 years. The water in the canals in Venice is clear and people can see fish. Wild animals are appearing in regions they have abandoned for generations. People worldwide now understand at a more profound level that we are all truly connected. Neighborhoods are displaying togetherness by serenading one another at night or displaying teddy bears in the windows. Most of us are recognizing that there is no place for racism or discrimination for any other reason in our society of the future.

Investments rise and fall based on the present value of expected future profits. Investment managers will have to be flexible and willing to change old ways of evaluating businesses and markets. Asked what his customers most wanted, Henry Ford is alleged to have said "faster horses." The Industrial Revolution took a century. The Digital Revolution has taken about 25 years. The COVID Revolution is taking only months. Evaluations of risks need to consider the short-term dislocations caused by current conditions and the longer-term trends related to climate change.

Investors have historically relied upon asset allocation, the relation between equities, debt and cash, to manage risk. Under many circumstances, different types of investments move differently from one another. Occasionally, as in March of this year, they all move in the same direction at the same time. In the future, it will matter more than ever before, WHICH industries are included in an investment universe and which will be omitted. Expected investment outcomes must be based on our current starting point, and not on historic outcomes.
As we look to the future of investment, people who understand ESG metrics will have a good start, but people who can distinguish right from wrong, and fairness from inequity, will be those who can truly provide leadership not just in investments, but in society at large.

George R. Gay CFP® AIF®
Chief Executive Officer