Intentional Investing

A category apart

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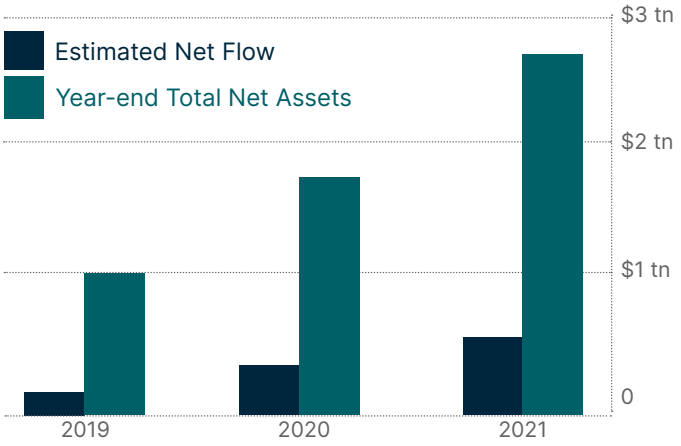
Introduction

Since Arnerich Massena's first white paper on the topic of sustainable investing in 2009, the landscape has made numerous twists and turns. What began as a relatively fringe approach in the 2000s has since expanded massively in its appeal, becoming woven into the fabric of the investment industry. Total assets in the ESG (Environmental, Social, Governance) market are estimated to be around $41 trillion currently, and are expected to increase to $50 trillion by 2025. (Kishan, *Bloomberg*, February 2022)

We are deeply pleased that investors are recognizing the challenges we face globally and seeking ways to deploy their capital that will contribute to a brighter future. Collectively, investors are powerful, and can create profound change by investing in solutions. And investors are realizing that this can be done not only without sacrificing return potential, but with an expansion of opportunities and increasing the potential for long-term growth and return.

At Arnerich Massena, we have been navigating this landscape for a long time; as pioneers in this area, we'd like to once again point in a new direction. While we are excited to see the ESG/impact movement take hold with investors' enthusiasm for investing responsibly, our research leads us to look at things from a new and slightly different perspective that we think can create an even greater alignment between an investor's goals and values and their investment strategy and portfolio. And we believe this approach will also better capture the opportunities posed by innovations

ESG Mutual fund and ETF Inflows and Assets



Source: Bloomberg, February 2022

IMPACT INVESTING IS "AN INVESTMENT STRATEGY THAT AIMS TO GENERATE SPECIFIC BENEFICIAL SOCIAL OR ENVIRONMENTAL EFFECTS IN ADDITION TO FINANCIAL GAINS. ESG (ENVIRONMENTAL, SOCIAL, GOVERNANCE) INVESTING IS A WAY TO MEASURE THAT IMPACT BY "LOOKING AT A COMPANY'S ENVIRONMENTAL, SOCIAL, AND GOVERNANCE PRACTICES ALONGSIDE MORE TRADITIONAL FINANCIAL MEASURES."

- Investopedia

and entrepreneurship in those areas we define as "what the world needs."

In this paper, we outline our vision of what it means to invest intentionally, how an intentional investing approach can be differentiated from ESG/impact investing, and why we think this difference matters for investors.

THE EXPANSION OF ESG AND MISUSE OF THE LABEL

With the growing demand for impact and ESG-rated investments, the industry has worked to accommodate that demand and generate an ever-expanding list of ESG and impact funds. The result is a broad landscape of approaches, some more truly ESG and impact-oriented than others. Ratings are based on a wide variety of metrics, and with such a strong incentive to earn a high ESG rating, companies and fund managers are quick to lay claim to social and environmental responsibility, sometimes based on thin substantiation. There are very dedicated, thoughtful, innovative strategies, but they are mixed in among other strategies that are marginally justified in claiming the ESG label. This isn't necessarily out of an intention to mislead or deceive (though much of this "greenwashing" is borderline misleading), but in an effort to answer an intensifying demand for accountability from both investors and consumers, and to engage with this growing trend.

For investors who are passionate and concerned about investing their assets responsibly, it has become a difficult landscape to navigate. Ratings and labels have become less meaningful as they become watered down and appropriated. The labels of "socially responsible," "ESG," or "impact" may not provide adequate information to understand the degree to which a strategy is truly focused on social and environmental responsibility versus adopting minimal adjustments in order to claim the title.

The U.S. Securities and Exchange Commission (SEC) has similar concerns: "The [SEC] is concerned that retail investors who want their investment managers to factor environmental, social, and governance considerations into investment decisions are being duped by 'greenwashing' — token actions with no material effects — and marketing materials that overstate what the managers are actually doing." (Aaron Brown, *The Washington Post*, May 2022)

Consider, for instance, the FlexShares ESG ETF Fund, which notes that its objective is "for investors seeking a focus on select ESG KPIs of global companies." The fund's top ten holdings (as of 3/31/22) are:

- Microsoft
- Apple
- Johnson & Johnson
- JP Morgan Chase
- Meta (Facebook)
- Alphabet (Google)
- Exxon Mobil
- Chevron
- United Health Group

While these companies may indeed earn a high ESG rating by some standards, they are not generally what an investor has in mind when they think of sustainability and responsibility. Four are giant tech companies and two are oil companies. "There are no universal rules to analyse ESG risk in most companies, or clear frameworks to police ESG-labelled investment products,"

"THE DAYS WHEN SELLING ESG FUNDS WAS AN EASY MARKETING PLOY FOR FUND MANAGERS ARE OVER. INVESTING BASED ON [ESG] GOVERNANCE CRITERIA HAS BEEN A HUGELY POPULAR NEW MARKET FOR FULL-SERVICE ASSET MANAGERS STRUGGLING TO COMPETE WITH LOW-FEE TRACKER FUNDS. WHILE THIS TYPE OF ETHICAL INVESTING CAN GENUINELY MEAN DIFFERENT THINGS TO DIFFERENT PEOPLE, SCRUTINY OF THE ENVIRONMENTAL PART OF THE CLAIMS IS RISING."

- Toplensky, *The Wall Street Journal*, June 2022

> **"MANAGERS OF MANY ENVIRONMENTAL, SOCIAL, AND GOVERNANCE FUNDS WERE SLAMMED IN 2020 FOR RUNNING WHAT AMOUNTED TO INDEX-TRACKERS THAT RELIED ON TECH STOCKS TO BEAT THEIR BENCHMARKS — ALBEIT WITH SHINY GREEN LABELS."**
>
> - Quinson, *Bloomberg* News, March 2021

says Assaad Razzouk of Eco-Business. "For example, deforestation is a major driver of climate change. You would think it's being used as a filter to ensure companies in ESG-labelled funds are not turning a blind eye to deforestation, but you would be wrong. Carbon Tracker, a think tank, found that 78 percent of mutual fund providers offered ESG investments but none specifically excluded deforestation risk." (Razzouk, *Eco-Business*; April 2021)

PUTTING THE FOCUS ON INTENTION INSTEAD OF RATINGS AND LABELS

This is where intentional investing comes in. Over the past few years, Arnerich Massena has refocused the firm's investment philosophy from impact investing to intentional investing; the change is not just about the language, but a redirection to a materially different approach. We want to share the fundamental principles on which we base our conceptualization of what it means to invest with intention and why it serves investors with greater clarity than ESG or impact investing.

We have seen firsthand the remarkable impact of thoughtful investing, and the growth potential of innovators and entrepreneurs seeking to build a more sustainable and just future. We want to refine the way we build portfolios and evaluate investments to capture that opportunity set. We think it is possible to align investors' portfolios with their values, and to do it without sacrificing return potential. But it requires a new perspective and new ways to describe the approach.

The term "intentional investing" is inclusive of social and environmental responsibility in investing, but extends to encompass a broader opportunity set. Whereas impact and ESG have served as a lens through which to evaluate investments, intentional investing focuses instead on the *investor's* goals and values, allowing for more latitude to tailor investments to fit into an overall portfolio strategy. We're not trying to match an investor with a certain set of investment opportunities, but rather to match investment opportunities to investors' needs and values.

The tenets of intentional investing

MAKE YOUR PORTFOLIO ABOUT YOU

If you or your organization are invested in working toward finding solutions to global issues, it should be because you are passionate about those issues. Your portfolio is not about how mutual fund companies define ESG; it's about what's important to you. And this is usually not one thing, but a series of priorities that often begin with building long-term security for your family and then extend out from there. Some investors want to invest locally or regionally, some look more toward global issues. Others may be interested in companies that are building innovative technologies, or want to focus on healthcare and life sciences. Social justice is a focus for many investors who want to feel assured that their investments are contributing to companies that are investing in equity and inclusion. And some investors are interested in a range of issues and solutions, requiring methods to prioritize and find ways to incorporate them into a larger strategy.

KNOW THYSELF

The Oracle of Delphi gave us this fundamental wisdom, prompting us to introspection. As an intentional investor, understanding your goals, priorities, principles, risk tolerance, areas of interest, and your dreams is important to crafting a strategy that makes your financial life a reflection of your deeper purposes. In addition to its practical uses, money serves to direct our energy. Knowing where and how you want to direct your energy will help drive your success as an investor; after all, the most significant metric is your satisfaction with your long-term portfolio performance and impact. One of our most important tasks as an investment advisor is to ask the questions that guide investors to

a better understanding of their own goals, values, and long-term hopes and dreams. You can only arrive at a destination if you have the map to get you there.

KNOW *WHAT'S* IN YOUR PORTFOLIO

For many investors, an ESG/impact investing strategy has meant putting some portion of their portfolio into an ESG, SRI, or impact fund and building the rest of the portfolio in a more traditional manner. Historically, this is how many investors and advisors have approached ESG/impact, treating it almost as an asset class with a separate allocation.

Intentional investing is about understanding your entire portfolio and how the pieces fit together. An intentional approach means assuring that all of the investments are aligned with the investor's goals and values, not just a small percentage. Different parts of the portfolio may be in different areas, but they are all playing a role in helping the investor move closer to their future vision, for themselves, their family, and their local and global community.

As we saw in the case of the top ten holdings of the FlexShares ESG ETF, many of those same holdings are in the S&P 500 Index and other large cap equity funds. Knowing what's in your portfolio helps you avoid duplicating assets where you should be diversifying assets.

KNOW *WHY* IT'S IN YOUR PORTFOLIO

Every holding in your portfolio should serve a particular purpose — or multiple purposes — that move you closer to your goals. Think of your portfolio as a very exclusive club; everything in it should be based on an intentional choice to include it, and the pieces should fit together neatly to form a larger strategy.

BE A VISIONARY

Focusing on the long term is good investment advice under any circumstance, but this tenet has particular applicability when investments are serving as a tool for crafting the future. Building long-term solutions to the challenges we face is a process, and there are generally no quick fixes.

If you've ever seen an advertisement offering something that looks too good to be true, you understand how advertisers play on the natural human impulse to want immediate results. A similar temptation can plague impact investors, and it's natural to want to see big impacts and changes. But the reality is that change is usually slow and incremental, and an investment thesis should recognize the nature of that process.

Though we may look toward and aim for an end-stage ideal — for instance, carbon neutrality or global access to clean water — there are investment opportunities in the interim stages as well that can offer significant growth potential, though they may seem less glamorous in the short term. Sometimes it is not the company that has achieved a sustainability goal or earned a sustainability score that is the most interesting

opportunity, but the company that is in the middle of or beginning of working toward solving a challenge. The greatest growth opportunities are usually along the way and in the process, not in the end result.

Intentional investing requires forward-looking vision and patience, and sometimes a little imagination. We invest in the existing world in an effort to create a better world.

SEEK THE UNCOMMON

Investors who have the willingness to explore avenues and ideas that are off the beaten track will not only have a broader opportunity set from which to draw, but are also more likely to be early adopters. We seek those extraordinary opportunities that are often at the leading edge, far ahead of the pack. It requires some courage to invest in innovation; we believe success comes when you combine that with a disciplined approach, stringent criteria by which to evaluate ideas, and a formula to guide the process.

KEEP A LONG-TERM PERSPECTIVE

Lastly, intentional investing is not a strategy for market timers. This is a long-term endeavor and requires a long-term outlook. We look for those investment opportunities that will perform across the market cycle throughout various phases of the market. While we may make adjustments at the margin based on current market factors and environment, we are overall seeking to build portfolios that will deliver long-term growth. We believe that using tools such as diversification and asset allocation, along with disciplined manager selection, are more successful over time than trying the time the market, which can often be influenced by emotional factors.

In the same way, seeking to drive impact and change is a long-term endeavor as well. Setting expectations and maintaining perspective is key to turning an investment strategy into a legacy.

Implementing intentional investing

Arnerich Massena has evolved its world-class research process over more than 30 years of collaboration and experience, drawing on expertise from internal research professionals as well as some of the best managers in the industry. We have also focused intently on listening to our clients and their needs in order to build a process that works in practical terms and delivers the outcomes that clients seek.

A fully customized and intentional portfolio is not necessarily practical, cost-effective, nor efficient for all investors. Our task in implementation is to balance an intentional approach while maintaining enough efficiency that the portfolio is reasonable in cost and maintenance. The investment industry is constantly evolving, with impact investment opportunities expanding exponentially, and we are constantly looking for ways to continue to develop and enhance our intentional approach.

For each client, we work to optimize their portfolio by making use of our research and resources while incorporating the issues and goals that are most important to them. Following are a few of the parameters that help guide our intentional investing implementation process.

WORK BOTH TOP-DOWN AND BOTTOM-UP

Intentional investing is both top-down and bottom-up, based on multiple layers of research. We build a top-down view based on forward-looking, collaborative discussion with the firm's Investment Committee, exploring the current landscape and projecting possible likely future scenarios. This discussion sets the stage for crafting a tactical approach that underpins our asset allocation strategies.

From there, specific investment selection may be more bottom-up, based on each manager's research and expertise and specific client objectives. We select managers to fulfill certain portfolio criteria, but we also use different managers for different client portfolios, based on their unique situation and needs.

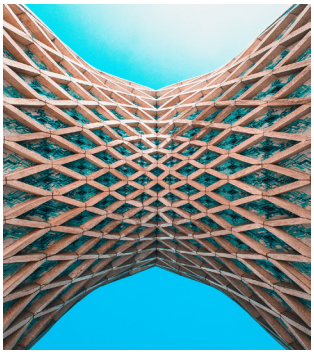
We also make use of separately managed accounts in order to access greater opportunities for customization, focusing on individual client interests and values. Clients are able to select areas of impact they want to emphasize, or screen out select industries they want to avoid. Separately managed accounts offer efficiency and tax advantages as well.

USE MANAGER SELECTION BEST PRACTICES

The same best practices we have used in our manager research since the inception of the firm apply to intentional investing strategies as to any investment strategies. See the following page for the manager selection criteria that drive our research process.

DIVERSIFICATION AND ASSET ALLOCATION

Whatever your long-term investment objectives are, diversification and asset allocation are two of the most important tools to help you achieve long-term success. We firmly believe in "time in the market" rather than "timing the market." We build asset allocation strategies that view the portfolio as a whole, not as separate "traditional" and "impact" portions. Including non-traditional asset classes such as hedge and diversifying strategies, private equity, and real assets can support the diversification of a portfolio, and these asset classes offer opportunities for both growth and impact that may not be available from publicly traded stocks and bonds.

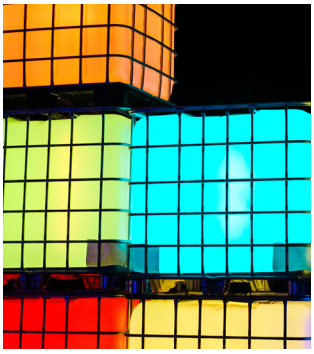


Alignment of interests

Managers whose interests are aligned with those of their investors and who actually have “skin in the game” have a strong performance incentive.

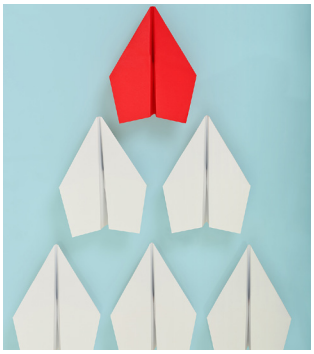
Focus on core competency

Managers with specialized expertise can focus in on and capitalize on targeted opportunities. Our research has found that fund families with a small number of similar funds tend to outperform those with a broad array of offerings due to their specialized knowledge and skills.



Discipline

We believe managers who demonstrate discipline when it comes to capacity constraints in their portfolios and prioritize existing clients and investors above raising capital will be more successful over the long term.



Portfolio differentiation

Although varying from the bench-mark may incur more risk, there is a greater potential for long-term outperformance with higher Active Share. We avoid funds that charge active management fees while essentially acting as closet indexes.

Long-term investment horizon

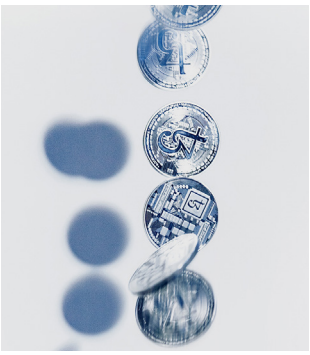
We are long-term investors, and look for managers who will base their fundamental strategies on full market cycles and maintain a long-term perspective, while remaining tactical.

Early adopters

Managers willing to take the risk to be early adopters are able to make the most of new opportunities when they arise. They may have less of a track record, but bring long-term experience and expertise.

Low turnover

High turnover of holdings in a strategy results in higher costs through both commissions and market impact. We generally seek managers who keep turnover low, both to reduce costs and to be consistent with a long-term approach.



Cost consciousness

We look for cost-efficient strategies with a clear relationship between the fees and the fund’s success ratio. Reasonable fees are appropriate, but we want managers who recognize their costs will ultimately be reflected in their performance returns.

IMPACT FIRST *AND* FINANCE FIRST

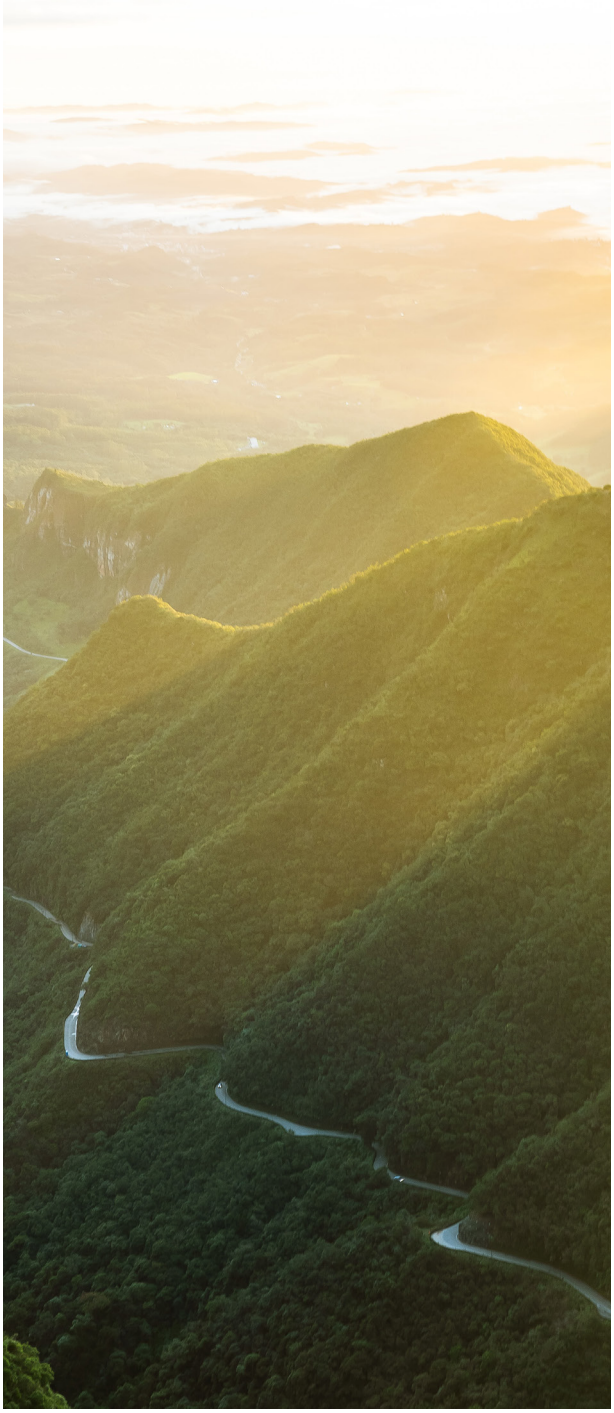
We do not believe in sacrificing return in the process of aligning your investments with your values, unless an investor is specifically intending to engage in philanthropy. Some in the industry refer to investments as either "impact-first," meaning an investment's projected impact takes precedence over the potential investment return, or "finance first," in which the financial return of an investment is a higher priority than its intended impact. We believe firmly that there are plenty of opportunities that are both impact first *and* finance first, sacrificing neither goal or outcome. We are dedicated to finding the opportunities that satisfy all of an investor's criteria.

Conclusion

A one-size-fits-all approach is just not adequate when it comes to values-aligned investing, which is why we developed intentional investing. ESG and impact investing have become so broadly defined as to make those labels minimally meaningful.

There is a growing movement among investors to look at their capital as a tool that can be wielded for good in the world while providing personal portfolio growth. Our task as advisors is to help guide those investors to the solutions that fit their long-term objectives. We believe that requires inquiry, reflection, and in-depth research.

Arnerich Massena has begun developing this more intentional investment approach to bring investors closer to their goals while aligning more deeply with their values. We have the expertise, curiosity, and tenacity to dig deeper and do the work.



If you are interested in learning more about intentional investing, please reach out to an Arnerich Massena team member.

ENDNOTES

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