Do You Know What You Own?

Investing As A Socially Conscious Consumer

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Socially-conscious investors may want to invest according to their values by avoiding companies with poor environmental, social, and governance (ESG) performance. Identifying companies to avoid is not an easy task, but it is even more difficult to know exactly what you own in comingled funds like mutual funds and exchange traded funds (ETF). Should you wish to manage your portfolio more in accordance with your values, there are tools available that can help you.

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If you are a conscious consumer, you probably make decisions in your day-to-day life to support good businesses and business practices. You may avoid certain products or companies because you disagree with their principles. You may shop locally rather than give your business to giant, multinational corporations. You may make charitable contributions to nonprofits that are active in your community. You may engage in any number of practices that help you spend your money wisely and ethically.

In addition, you probably also have a retirement portfolio and other personal investments, which are invested in a range of securities that likely includes mutual funds and ETFs. Depending on what you own in your portfolio, you may be invested in the very companies you choose to avoid in your day-to-day life. Compared to reading an ingredient list, seeking out locally-made products, or finding a charity whose mission addresses a cause important to you, it can be much more difficult to "know what you own," or know if your investment choices reflect your values.

In this analysis, we discuss a few issues you may consider in choosing how to spend your money, some common types of funds (and firms) in which you may be invested, and a few steps you can take if you want to ensure your retirement portfolio reflects your values.

What Makes a Good (Or Bad) Company

You probably already have strong opinions about which companies you want to patronize or avoid. Some of these opinions may be very personal—for example, we all care about different social causes to varying degrees. In addition, there are a wide range of ways that firms can handle common environmental, social, and corporate governance (ESG) issues, which probably guides whether you think of certain companies as well run and ethical. In the following pages, we discuss these types of issues and how firms can choose to respond to them, as well as look at a few real examples of how companies have reacted to these issues in the past.

Environmental Issues

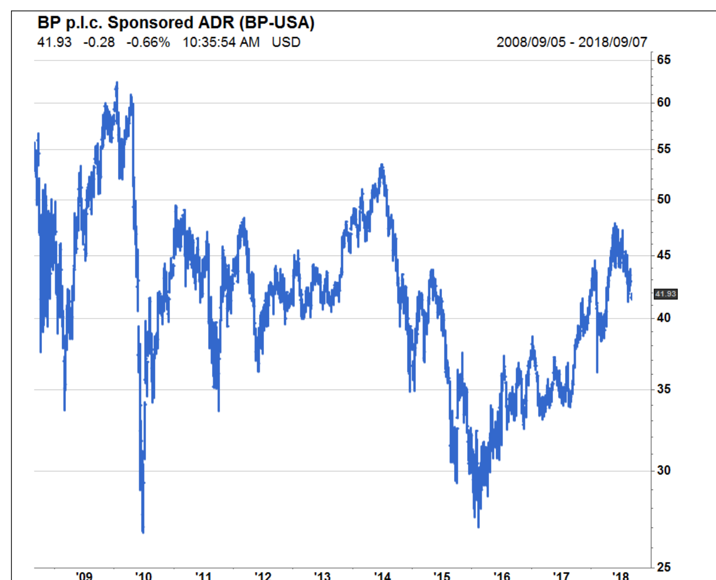
To a certain extent, all firms deal with environmental issues. Even if a company does not create any physical products, they still have an environmental footprint through the electricity required to run computers and the kinds of cleaning products used in their facilities.

When a firm refers to its sustainability program, it is typically referring to practices like incorporating renewable energy into their production processes, managing their energy use via LEED-certified or green buildings, setting high environmental standards for their supply chain,

and encouraging employees to limit their business travel. Some firms may even offset their energy use by making donations to environmental nonprofits or purchasing carbon offset credits.

When considering environmental issues, the kinds of companies that come to mind are probably known for their negative environmental impact. You might have thought immediately of BP, the British oil and gas company. BP has been involved in several environmental disasters, but the largest and most expensive was the *Deepwater Horizon* oil spill. In April 2010, an explosion aboard the *Deepwater Horizon*, an offshore rig drilling a a deep water oil well in the Gulf of Mexico, sank the rig and led to an oil leak out of the well. It took 87 days to stop the leak, during which time an estimated 3.1 million barrels of oil spread into the Gulf.[1] The spill was disastrous for marine wildlife, caused health problems for cleanup workers and Gulf residents, and damaged the local economy.

While the spill was the worst in the company's history, it was far from BP's first safety failure. In the five years prior to the spill, BP received 97% of the citations given to oil companies by the Occupational Safety and Health Administration (OSHA) for safety violations. In 2005, BP paid $50 million in fines for the Texas City refinery explosion that was caused by BP failing to follow mandated safety procedures. Five years later, BP paid an additional $87 million in fines because they still were not following those safety procedures. In 2007, BP was fined for ignoring corrosion of the Prudhoe Bay pipeline for so long that an oil spill occurred. At the time of the Gulf spill, BP arguably had the worst safety track record of any major oil company operating in the U.S.[2]



In the investigation that followed the *Deepwater Horizon* spill, it was determined that BP was at fault due in part to their poor safety practices.[3] BP pled guilty to 11 felony counts of misconduct and neglect, two misdemeanors in relation to environmental acts, and an additional felony count for lying to Congress. They paid a $4.5 billion penalty in connection with these criminal charges.[4] By 2013, BP had paid $42.2 billion towards penalties, cleanup, and restitution to victims,[5] and in 2015, BP

[1] https://ocean.si.edu/conservation/pollution/gulf-oil-spill

[2] https://abcnews.go.com/WN/bps-dismal-safety-record/story?id=10763042

[3] https://www.britannica.com/event/Deepwater-Horizon-oil-spill-of-2010

[4] https://www.theguardian.com/environment/2012/nov/15/bp-deepwater-horizon-gulf-oil-spill

[5] https://www.forbes.com/sites/afontevecchia/2013/02/05/bp-fighting-a-two-front-war-as-macondo-continues-to-bite-and-production-drops/

reached an additional settlement with five Gulf states at $18.7 billion, the largest corporate settlement ever in the United States.[6]

Fortunately, BP has spent a lot of money to improve its safety and environmental initiatives since the *Deepwater Horizon* incident, but the financial impact on investors who owned BP prior to the *Deepwater Horizon* spill was nothing short of horrible. This is an extreme example of an environmental issue, but it highlights that firms can directly help or harm the environment through their products, policies, and sustainability initiatives. An environmentally conscious investor could choose to invest only in clean energy companies or seek out firms with strong environmental and safety initiatives.

Social Issues

Depending on your feelings about certain social causes, some companies may seem better or worse based on the type of product or service provided. Certain consumers just disapprove of companies that make certain products; for example, a non-smoker may disapprove of and avoid companies that produce or market cigarettes. On the other hand, a consumer may enjoy Starbucks coffee and also appreciate their sustainable coffee sourcing. Like or dislike of a company based on how they contribute to social issues is very personal, but it certainly guides decision-making as a consumer.

Companies on the unpopular end of this spectrum often end up included in lists of so-called "vice stocks," "sin stocks," or "socially irresponsible investments." Alcohol, tobacco, firearms, and gambling are generally categorized as vices in the market. A less obvious socially irresponsible investment (but equally objectionable to many) is the private prison industry. A major player in that industry is the GEO Group, a Florida-based correctional services firm. The GEO Group operates prisons of multiple security levels, immigration detention centers, and mental health facilities in the United States, Australia, South Africa, and the United Kingdom, and about 45% of its revenues come from contracts with the U.S. Federal government.[7]

While private prisons are generally controversial, the GEO Group has a long history of questionable business practices. The firm has been sued numerous times due to deaths of inmates and staff in their facilities, riots, providing inadequate medical care to and mistreating inmates, and more. In recent years, the GEO Group has attracted more attention for terrible conditions in its immigrant detention facilities, which have been the subject of multiple inquiries. The firm is currently the subject of a class-action lawsuit that accuses GEO Group of violating the U.S. Constitution and federal antislavery laws by forcing current and former immigrant detainees in Aurora, CO to work for less than $1 per day or for free.[8]

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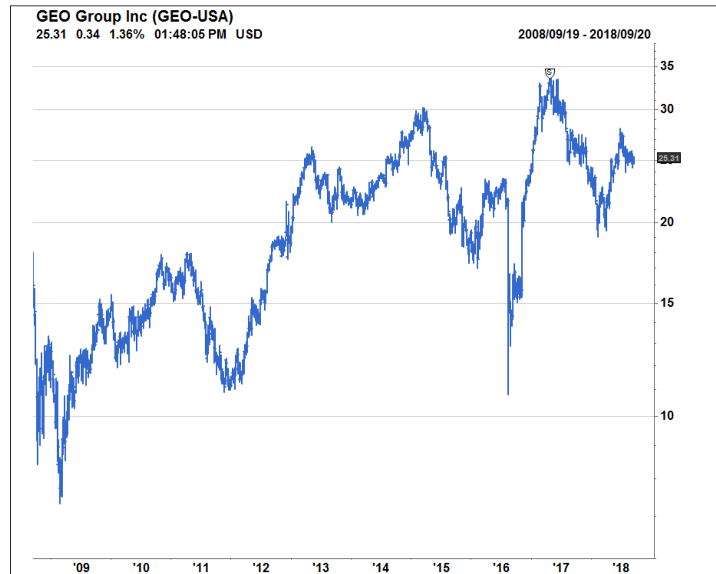
[6] https://www.washingtontimes.com/news/2015/jul/2/gulf-states-reach-187b-settlement-with-bp-over-oil/

[7] https://en.wikipedia.org/wiki/GEO_Group

[8] https://www.washingtonpost.com/news/post-nation/wp/2017/03/05/thousands-of-ice-detainees-claim-they-were-forced-into-labor-a-violation-of-anti-slavery-laws/?utm_term=.8a300ad7e202



In December 2017, a 64-year-old Iranian man died of cardiac arrest in the Aurora, CO immigration detention center. The cause of death is still being investigated in part by the ACLU, in part because of the history of the facility.[9] In 2012, a 46-year-old died of cardiac arrest in the same detention center, and the investigation that followed showed that the staff of the facility didn't know how to properly use an EKG machine and delayed in calling an ambulance.[10] The ACLU extensively covers deaths in Immigration Customs Enforcement (ICE) detention facilities, and the GEO Group is frequently investigated.[11]

There is ongoing debate about whether private prisons ought to exist at all, but even for a controversial industry, the GEO Group stands out as a particularly bad actor. While it would be impossible for an average consumer to "patronize" a company like the GEO Group, these types of socially irresponsible firms are often avoided as investments on moral and ethical grounds.

Corporate Governance Issues

Corporate governance is the system of rules and processes that dictate how a firm is managed. These rules are intended to guide the firm's behavior in such a way that the interests of shareholders, management, customers, the board of directors, and other stakeholders are properly balanced. Good corporate governance provides clear, transparent, and ethical guidance for the firm, and it helps create and maintain firms that are typically viewed as good corporate citizens.

Corporate governance is a very broad category, so it should be no surprise that failures of corporate governance can take many forms. If a firm publishes false or incorrect financial statements, creates misaligned incentive packages for its CEO and other C-suite executives, or makes it too difficult for shareholders to remove bad management, one would say that the company has poor governance.

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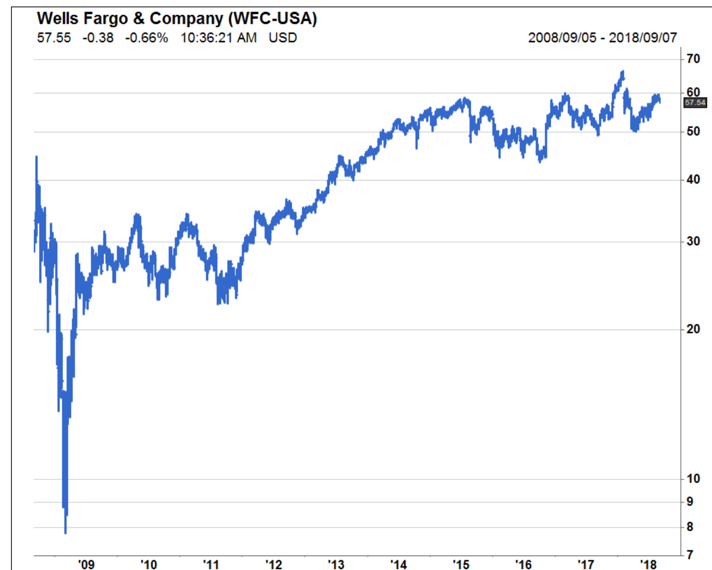
[9] https://www.thedenverchannel.com/news/local-news/aclu-claims-secrecy-shrouds-colorado-ice-cases-amid-iranian-detainee-s-death

[10] https://www.westword.com/news/aclu-of-colorado-investigating-death-of-kamyar-samimi-at-aurora-immigrant-detention-center-9809950

[11] https://www.detentionwatchnetwork.org/sites/default/files/reports/Fatal%20Neglect%20ACLU-DWN-NIJC.pdf

One recent, newsworthy example of poor corporate governance comes from Wells Fargo. In September 2016, Wells Fargo was ordered by the Consumer Financial Protection Bureau (CFPB) to pay $185 million in fines because employees had created over 2 million bank and credit card accounts that had not been authorized by customers. These customers were collectively charged over $2 million in fees on accounts that they did not even know existed, and 5,300 employees were fired for opening the accounts.[12]



While there were many cultural issues at Wells Fargo that allowed this to happen, a significant cause was a poorly designed incentive system for employees. Wells Fargo encouraged its employees to sell multiple products to consumers and to open as many new accounts as possible. To do so, management based performance goals and compensation on aggressive daily sales quotas, and managers reportedly enforced these quotas through a combination of threats, termination, and forced overtime. Employees responded by signing existing customers up for new accounts without their consent: employees would get an account number, sign a customer up with fake contact information, and transfer money from a customer's legitimate account to the fake account if necessary.

Not only was this incentive system fraught with flaws, exposing the company and its customers to excessive risks, but Wells Fargo had been warned that quota numbers were too high and employees were cheating both by the employees themselves and its customers.[13] It took until 2016, but Wells Fargo finally became the subject of enough scrutiny that regulators investigated and eventually fined the company with the biggest penalty ever issued by the CFPB.

Wells Fargo is an extreme example of poor corporate governance. Not only were its performance and compensation policies poorly designed, but also there appears to have been little oversight by management and the board of directors. Wells Fargo's board of directors rubber-stamped management's assertion that nothing was wrong with its internal processes, and even when issues came to light, they waited for years to respond. It took the storm of bad publicity after the fines for the board to remove executives and reclaim compensation from some who had already left the company. A firm with strong governance would have had better oversight of operations and an active board that would have taken quicker and more decisive steps when allegations

[12] https://www.bloomberg.com/view/articles/2016-09-09/wells-fargo-opened-a-couple-million-fake-accounts

[13] https://www.vanityfair.com/news/2017/05/wells-fargo-corporate-culture-fraud

began to surface. While good corporate governance helps a company function well and ethically, poor governance can be responsible for company-wide issues of the scale at Wells Fargo.

The Good and the Bad in Mutual Funds

Chances are that you hold stock in a few individual companies in your portfolio as well as a selection of mutual funds and ETFs. These funds typically track a specific market index (like the S&P 500 or the Dow Jones Industrial Average) or only include companies of a specific type (like small- or mid-cap companies), and diversify your portfolio by allowing you to hold a wide selection of stocks through one investment product.

Unfortunately for the socially conscious investor, many of the most common funds—ones you are likely to own yourself—also have exposure to the kinds of companies described above. Several of the most common types of mutual funds, including S&P 500 index funds, small- and mid-cap funds, and international funds, include numerous companies that many investors would prefer to avoid.

S&P 500 Index Funds

The single most common type of fund is one that tracks the S&P 500 Index. The S&P 500 is an index based on the market capitalizations of 500 large, publicly-traded U.S. companies. Many companies that are household names are included in the S&P 500, including Amazon, Apple, and Johnson & Johnson. There are a wide range of mutual funds and ETFs that "track" the S&P 500, holding an amount of stock in each company equal to their weight in the index itself.

S&P 500 index funds are very popular financial products: in 2017, two of the five largest mutual funds by assets under management tracked the S&P 500, and two more were total market indexes (which, in practice, are shockingly similar to the S&P 500 index).[14] And with good reason: S&P 500 index funds are typically cheap to hold, offer great diversification, and have historically boasted strong returns.

A potential issue with simply holding an index of 500 very large public companies is that size is the primary criteria for inclusion in the index, not whether investors might want to hold the company's stock. For example, Wells Fargo is part of the S&P 500. If you own the Vanguard 500 Index Fund—one of the largest mutual funds—1.02% of your holdings are invested in Wells Fargo. If you own the SPDR S&P 500 ETF, 1.05% of your holdings are invested in Wells Fargo. These seem like small percentages, except that Vanguard's Total Stock Market Index, 500 Index, and the SPDR ETF are the three largest fund shareholders in Wells Fargo, collectively owning about 5% of the company.[15]

[14] https://www.investopedia.com/investing/biggest-mutual-funds/

[15] All mutual fund and ETF data comes from Morningstar. Accessed on 7.5.18.

Of course, Wells Fargo is not the only questionable company in an S&P 500 index. United Airlines and Equifax—both on the list of America's top 20 most hated companies[16]—are constituents of the S&P 500. Phillip Morris, a major manufacturer of cigarettes, is also part of the index. Roughtly 6-7% of the S&P 500 is allocated to the energy sector, primarily large oil and gas companies. Owning an S&P 500 or total market index ensures that you are (perhaps unknowingly) invested in companies like Wells Fargo, even if you would never give those companies your business as a consumer.

Small- and Mid-Cap Funds

Small- and mid-cap funds and ETFs contain an assortment of companies that have smaller market capitalizations than those in the S&P 500. A company with a market cap between $300 million and $2 billion is generally considered small-cap (including firms like 1-800 Flowers and Steelcase), and one with a capitalization between $2 billion and $10 billion is generally considered to be a mid-cap company (firms like Jack in the Box and Steven Madden). These types of funds offer a seemingly endless variety of options: funds may be focused on mid-cap companies plus some other investment criteria, they may track an index like the S&P Mid-Cap 400 or the Russell Mid-Cap, and they may be actively or passively managed.

Much as in the S&P 500 indices, small- and mid-cap index funds can also contain objectionable companies. The GEO Group falls into small- and/or mid-cap indices, as does its main publicly-traded competitor in the private prison space, CoreCivic. A socially-minded consumer could easily be invested in the private prison industry and have no idea that any of their money is going to support highly objectionable practices.

Additionally, small-and mid-cap index funds are home to another prominent type of "vice stocks": gun manufacturers. One such firm is American Outdoor Brands Corporation, but you are probably more familiar with their principal brand: Smith & Wesson firearms. The company used to be known as Smith & Wesson Holding Corporation, but in 2017, they changed their name to American Outdoor Brands Corporation, conveniently removing any reference to guns.[17] Sturm Ruger & Co., Inc., another firearm manufacturer, also falls into small-cap indices. Many outdoor enthusiasts own Giro or Camelbak products, but may not know that these brands are owned by Vista Outdoor, a small-cap company that derives rougly 50% of revenues from the sale of guns and ammunition. Even if an individual investor would never choose to invest in a firearms manufacturer, he or she could be invested in American Outdoor Brands Company, Vista Outdoor, and Sturm Ruger simply by owning a small-cap index fund.

World Index Funds

Another common type of fund incorporates companies headquartered outside the United States. Global index funds combine U.S. investments and global investments by tracking world stock

[16] https://www.cbsnews.com/news/americas-most-hated-companies/

[17] https://www.fool.com/investing/2016/12/20/why-smith-wesson-changed-to-american-outdoor-brand.aspx

indices, and there are other types of international and emerging markets funds that can give investors international exposure and additional diversification.

As with S&P 500 indices, these funds are designed to track certain benchmarks and do not include any socially-focused criteria. As a result, firms like BP appear in international index funds: the Vanguard Total World Stock Index is 0.28% invested in BP, representing 6 million shares in the company.[18] It also includes 0.25% in Royal Dutch Shell PLC (1.1 million shares) and 0.66% in Exxon Mobil Corp (1.3 million shares); both of these companies have been responsible for significant oil spills and environmental cleanups in the past. The World Index also contains BHP Billiton, the world's largest mining company by market capitalization. As with small- and mid-cap funds, investors may find themselves holding the stock of companies that they would never voluntarily support by investing in a broad world index fund.

Outside the United States, an investor is also likely to encounter firms with severe social issues. Not all countries protect workers as the United States does, so exploitation and child labor are more common in non-U.S. firms. Corruption is also more common in the rest of the world. Transparency International publishes an annual Corruption Perceptions Index, which surveys experts and businesspeople on perceived levels of public sector corruption.[19] Countries are awarded a score between 0 (very corrupt) and 100 (very clean), and in 2017 two-thirds of the world's countries scored below a 50. An investor who wants global exposure through an index would have a difficult time excluding firms with social issues from their portfolio given their prevalence in global indices.

What About Socially Responsible Funds?

While holding various mutual funds and ETFs can add essential diversification to your portfolio, investing in a strictly index-tracking fund is likely to ensure that you are invested in companies that you may prefer to avoid. Fortunately for the conscious consumer, there are options for those looking to hold a more responsible portfolio, but unfortunately, these options are often confusing, misleading, or simply not individualized enough to meet the needs of investors.

As more and more people have become interested in investing according to their values, numerous mutual funds and ETFs have been developed that include some sort of ESG screening criteria in their selection of investments.[20] A investor can now choose from an array of socially responsible funds, selecting a generally responsible fund or a fund without oil and gas stocks, for example. These funds are constructed either by taking an index like those discussed above and excluding companies based on certain ESG criteria or by selecting companies based on ESG criteria and creating a new fund.

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[18] The World Index includes over 8,000 individual stocks, so individual stockweightings in this portfolio are extremely small; the largest weighting is on Apple at 1.81%.

[19] https://www.transparency.org/news/feature/corruption_perceptions_index_2017

[20] https://www.economist.com/finance-and-economics/2017/11/25/sustainable-investment-joins-the-mainstream

It is getting easier for the average investor to find responsible options, but it is still difficult for that investor to know exactly what he or she is getting in one of these funds. For example, the Vanguard FTSE Social Index Fund is a cheap, well-diversified fund with a social focus and a good score in Morningstar's sustainability ranking. This fund is designed to filter out stocks with poor ESG characteristics, which means it excludes businesses involved in tobacco, alcohol, gambling, poor labor standards, and more.

The result is a much more socially responsible fund than an S&P 500 index. But the Vanguard fund does not exclude Wells Fargo, and actually allocates a larger percentage of the fund to Wells Fargo than a traditional S&P 500 index. It also does not exclude the other too-big-to-fail banks or oil and gas companies. Likewise, Fidelity's US Sustainability Index Fund, another large, well-diversified index fund, also includes too-big-to-fail banks and oil and gas companies. Even a product marketed as socially responsible may not exclude certain types of companies, or it simply may not match the causes that you care about as an investor.

Part of what makes socially responsible investing difficult is that there is no single standard for what "social responsibility" looks like. What should you measure to determine if a firm is socially responsible? And how do you measure it? How do you track these criteria consistently in mutual funds and ETFs? It is not just that every fund can have its own definition of socially responsible investing, but the data sources that are supposed to help determine if a company is doing well or poorly also don't agree on what criteria to consider.

For example, Morningstar has a sustainability rating system that ranks funds from one to five globes, with five globes representing the most sustainable. This system compares funds within a category to each other to determine their score. The problem with this system becomes clear when looking at the Natural Resources category: there are funds in that category that receive five globes despite owning essentially nothing but extractive (oil, gas, mining, etc.) companies. Looking at the number of Morningstar globes a fund receives tells you something about its sustainability performance relative to its peers, but it does not tell you much about its absolute impact on the world from an ESG standpoint.

Of course, personal preferences matter in ESG investing, as well. Just as there is not yet a consistent way of measuring social responsibility, there is no "one size fits all" investment product for all investors' preferences. This is unlikely to change—different people will always care about different causes—but hopefully it will become easier to determine what products are the right fit for your particular needs.

I Want to Invest Responsibly—What Do I Do?

If you are buying products or services, it is relatively straightforward to avoid "bad" companies: most of the time, you can just make your purchase from a competitor. But when it comes to your investments, it is much more difficult to know what you're getting in a large mutual fund, and the alternatives are much less clear. Whether a company is "good" or "bad" is also often less clear-cut than in the examples we've discussed in this analysis. No firm is going to handle every issue perfectly, so in reality most firms are going to land somewhere in the middle of the spectrum from responsible to irresponsible. A consumer has to consider a firm's behavior, its intentions, its plans for the future, and more when making judgments about what companies to buy from or own. It can be difficult to evaluate whether a company is being a good corporate citizen, and once you have decided, it can be difficult to make investment decisions based upon that evaluation.

This analysis has only scratched the surface of issues that might matter to you as an investor and the types of mutual funds and ETFs that you may have in your retirement portfolio. While investing according to your values can be challenging, there are ways for you to become better informed about what is in your portfolio and take steps to remove objectionable companies.

If you want to learn more about what you own, there are some free online resources that will help you begin the process of examining your current retirement portfolio. For example, the nonprofit As You Sow offers a series of tools that allow you to self-screen the mutual funds in your portfolio for investments in fossil fuels, weapons manufacturers, deforestation, and tobacco products.

By knowing what you own and making investments that are consistent with your personal beliefs, you can use your retirement dollars for good.

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