ADKINS SEALE CAPITAL MANAGEMENT, LLC
Investment Commentary
July 8, 2021

Dear Clients:
One of the more noteworthy and recent developments in investing strategy is the pursuit of "conscience-driven" investment outcomes. The call for broad consideration of environmental, social, and governance (ESG) investing permeates the media, the investment industry, and the investment regulatory (aka political) regime. To enhance our firm's understanding of this process, we have reviewed the processes used by major index providers to create ESG indices as well as the investment outcomes of the larger ESG index funds available to the investing public.

Both MSCI and S&P Global maintain multiple stock indices that attempt to capture the investment results from a stock universe comprised of companies that meet certain guidelines to qualify as being ESG compliant. The two index providers both use a list of disqualifying industries for exclusion from an ESG index. S&P Global excludes any company with significant operations involving coal, controversial weapons, and tobacco. MSCI's list is more robust and additionally excludes conventional weapons, civilian firearms, alcohol products, gambling activities, nuclear power, and "fossil" fuel extraction.

Both index firms use internally generated ratings to estimate the relative strength of a firm's adherence to ESG principles. MSCI generates four unique ratings for ESG: ESG Overall, ESG Controversies, ESG Business Investment, and ESG Climate Change. Each company is given a score for each of the ratings and index inclusion is determined based on the achievement of a minimum score. For example, companies are rated from AAA to CCC for ESG Overall and a minimum of BB is required to be considered for inclusion in the index. The ratings for ESG Controversies are scored from 0 to 10 with a minimum of 3 required for inclusion consideration. S&P Global uses a different approach involving the creation of a single ESG Score derived from its "Corporate Sustainability Assessment." The S&P Global exclusion process also utilizes outside ratings from independent firms RepRisk and Sustainalytics (a division of Morningstar) as well as comparison to the principles of the United Nations Global Compact. Unlike financial statement/accounting metrics, these ratings involve a substantial degree of subjectivity and political nuance. Unsurprisingly, both index firms offer their ratings and index constituents to the investment management industry and the public for a fee.

Three of the major index fund sponsors – Blackrock, Vanguard, and Fidelity – offer ESG index funds. Quite surprisingly, the US ESG index funds for these three companies are comprised very differently. The Blackrock Ishare fund has total holdings of 351 stocks and a reported turnover ratio of 38%. Comparable measures for Vanguard and Fidelity were 1,463 and 6% and 276 and 8%, respectively. Weighted average market capitalizations for all three funds were similar to that of the S&P 500 Index or solidly in the US large cap equity space.

Inception dates go back only to 2017, so the return history is quite short and will need to be monitored over a longer period of time to judge outcomes properly. Nonetheless, the comparison of ESG index fund returns to broad index returns is revealing. All three of the ESG funds generated higher total returns than that of the S&P 500 Index, with excess annualized returns ranging from 0.60% to 0.95%. The favorable return outcomes were achieved almost exclusively from under-weights to energy and utility companies; both sectors have lagged the broad index for several years. What was surprising was the near perfect correlation between the returns of the ESG funds and the broad stock indices. So, in terms of market fluctuations, the ESG index funds exhibit return behavior virtually identical to that of the broad market. Over weights to the technology sector was a typical contributor to the return advantage.

What should investors conclude from this assessment? We suspect some, if not most, of the motivation behind the support for ESG investing relates to a concern that "capitalism and free market principles" are not sufficient to address society's broad interests. Market forces have been at play over the past twenty five years to lower the weighting of the energy and utility sectors from around 12% each to slightly less than 3% each today. This reallocation of market weights has lifted technology, health care, and financial companies, all of which can be seen as raising the quality of the collective standard of living. For all we know, the recent advances in technology, social media, health care and renewable energy may one day be viewed very differently and even less favorably. Our take is that any successful and sustainable company will carefully consider the impacts of its operation on the environment, the community, its clients, its suppliers, and its employees. The power of the market's invisible hand in directing resource allocation to its highest and best use should not be over sold, and the efficacy of centralized government planning should not be over bought.

Investment Market Returns as of June 30, 2021

Market returns for both equity and fixed income assets continued to rise on the strength of favorable price appreciation despite less than exciting income characteristics. For equity assets, increasing earnings multiples have produced above average total returns both in the US and abroad; the trailing total returns for the MSCI World Stock Index USD for the current quarter, last twelve months, and last five years were 7.4%, 40.9%, and 14.9%, respectively. Equity price multiples for the broad indices are nearly twice the historical norm suggesting a significant portion of the forward return is already reflected in current prices. Fixed income returns are barely positive on a forward yield basis, with a negative yield after inflation; the trailing total returns on the BloombergBarclays Multiverse Bond Index USD for the same three time periods were 1.5%, 3.2%, and 2.6%, respectively. Unlike equity investments, a growth opportunity for bonds only happens in a deflationary environment coincident with owning bonds that will be redeemed at par.

Our Look Forward

The margin of safety and forward return expectations in the current prices of marketable securities remain low, which subjects account valuations to higher volatility should investor sentiment turn more bearish. The spread between forward equity and bond returns has narrowed significantly over the last few months, making the reward for over weighting stocks considerably smaller. This expectation suggests maintaining material allocations to short duration bonds as a reasonable defensive approach at an acceptable cost for lower portfolio returns. The appropriate asset allocation recipe for investors remains tied to the facts and circumstances of each situation, with time horizon and capacity for adjusting periodic withdrawals continuing to be critically determining inputs.

In Closing

We look forward to visiting with each of you about your investment results and expectations for the future and to make sure your portfolios are aligned with your specific circumstances. We greatly appreciate the opportunity to serve as your investment adviser and pledge our best efforts to meet your expectations.

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