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Sustainable and Responsible Investing

By Joyce Franklin

Recently, a friend asked me about an opportunity to invest her portfolio in "green" investments. My friend lives on the income and earnings her portfolio generates to meet her expenses now and for the next 35 years. I was very concerned.

The "green" portfolio proposition

The idea of a sustainable investing strategy felt good to my friend, so I helped her look beyond the glossy brochure to view the underlying investments. Here's a summary of some of the holdings in her proposed portfolio and our concerns about each:

Gold bullion and gold mutual funds. Investments in gold include mining, which uses pollutants. Returns are extremely volatile and speculation determines its pricing.

High-yield bonds/junk bonds. This asset class experienced a huge run-up between late 2008 and 2009, but now valuations are back to reasonable levels. High-quality fixed income is preferred over high-yield bonds for principal preservation.

Treasury inflation protected securities (TIPS), current yield 3.8 percent. Although TIPS and other U.S. bonds aren't invested in corporate America, an investment in TIPS helps the U.S. government fight wars.

Individual stocks (renewable energy, global water, timber). Owning only a small number of companies is risky.

Sustainable and responsible investing (SRI)

An investor voting for sustainable and responsible business practices should ask: What's my definition of sustainable and responsible? At least 30 percent of my friend's proposed portfolio didn't have much to do with SRI, even though it was marketed to her as "green." A better investing style is a diversified portfolio with holdings in large and small companies worldwide.

Investors must also consider their portfolio's total cost. Adding social screens increases fees versus index funds. Social investing generally means more investments in growth-oriented companies, such as high tech (which, over time, tend to underperform value-oriented companies). A pure SRI portfolio is biased toward growth and small cap, with less exposure to U.S. large cap value (such as energy) and international companies.

A large number of low-cost, tax-efficient holdings are preferable. This ensures returns of the worldwide market and has a higher chance of reaching long-term financial goals.

Tastes and preferences

Companies involved in the manufacture or sale of tobacco, alcohol and firearms are screened out in most socially responsible funds. Are avoiding these (or other things) important to you? To own an investment portfolio that truly mirrors your values, do your homework.

Beyond social criteria, you must still make investment selections. Given the difficulty of consistently beating the benchmarks in the overall fund universe, and given the relatively few funds that practice SRI, it's no surprise that no clear standouts emerge. Investors pursuing SRI should consider index options.

An SRI solution

Achieving long-term goals is obtainable through prudent and carefully constructed asset allocation. Focus first on designing a reasonable investment solution, then on layering in an SRI bias. You must also understand if your existing assets will let you maintain your standard of living in retirement. Then, decide if you can afford to compromise portfolio returns to meet your sustainable or socially conscious investing goals.

If SRI makes sense and you're willing to forego some investment returns to limit your investment universe, a portfolio that blends growth and small cap with some large cap value that meets certain SRI screens can be created. A sustainability overlay provides exposure to companies highly rated for sustainable practices and reduces or eliminates companies with low ratings. You can then choose from socially conscious or sustainable investing.

Socially conscious investing means reduced exposure to companies that fail certain social screens. Social screens are used to identify companies engaged in things such as the making or selling of military weapons, alcohol, tobacco, pharmaceuticals, as well as those involved in gambling, pornography and human rights violations.

A sustainable investment portfolio favors companies pursuing economic growth and development that meets today's needs without compromising those of future generations. By investing in this portfolio, you provide seed money to thousands of environmentally responsible companies that also boast strong SRI scores. Evaluation considerations can include negative factors such as agricultural and ozone-depleting chemicals, climate change, hazardous waste, regulatory problems, substantial greenhouse gas emissions but also reflect positive factors such as clean energy, environmental management systems, pollution prevention and recycling.

Don't let the SRI tail wag the dog

It's easy to under-perform the market. Most investors tend to buy high and sell low when they let emotions creep into their investment philosophy. Long-term disciplined investors have historically earned higher returns than those who attempt to time the market.

Your own financial independence should be the highest priority. In other words, take care of yourself first. Prepare a comprehensive financial projection to determine if you're on track to achieve your financial goals. If applicable, identify excess resources and invest in SRI companies. Otherwise, a "fun money portfolio," which should be no more than 5 percent of your total investable assets, can be created for this purpose.

For my friend, a deeper review of the proposed holdings and her financial goals convinced her to stay with her current, globally diversified investment mix. If you aren't convinced you're ready to give up returns to pursue investing with a sustainable or social intent, consider making direct cash or stock contributions to your favorite social causes, volunteer time to local charities and let your investment portfolio reflect the broad global market. With this strategy, you have the highest chance of achieving your long-term goals. And with investment success, you can more effectively do good by directly giving cash or your time to those organizations advancing your philosophical views.

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