Lebed
Asset Management LLC

Six Beacon Street
Suite 925
Boston, MA 02108
Ph: 617.722.8322

Investment Commentary—October 2021

Global stock markets continued their steady ascent in July and August as U.S. stocks once again led the way. That changed in September with the S&P 500 declining nearly five percent for the month. The Delta variant of Covid-19 has weighed on the U.S. economy, but case numbers were getting better just as the market decline began. Supply shortages, which are widespread and affecting most sectors of the global economy, may be a bigger problem. It's hard to know when shortages will ease up, but semiconductor chip supply, which is hampering the all-important auto sector, isn't expected to normalize until well into 2022. Supply constraints can accelerate inflation and slow the economy at the same time—a bad combination for corporate profits.

Concerns over the U.S. debt limit have been an issue as well. The idea that Congress would jeopardize the full faith and credit of the U.S. government seems unthinkable, which is why a deal always comes together. Last week's last-minute agreement kicked the can down the road for a mere six weeks or so, but the stock market seemed pleased with a short reprieve and promptly recovered much of September's decline.

Despite the worries noted above our baseline scenario is that the U.S. and global economy will muddle through the next few quarters, supply shortages and inflation will gradually abate, and the global economic recovery will regain momentum. In the meantime, the U.S. stock market hadn't had a five percent pullback in eleven months, so some sort of retrenchment was overdue.

An ESG Investing Primer

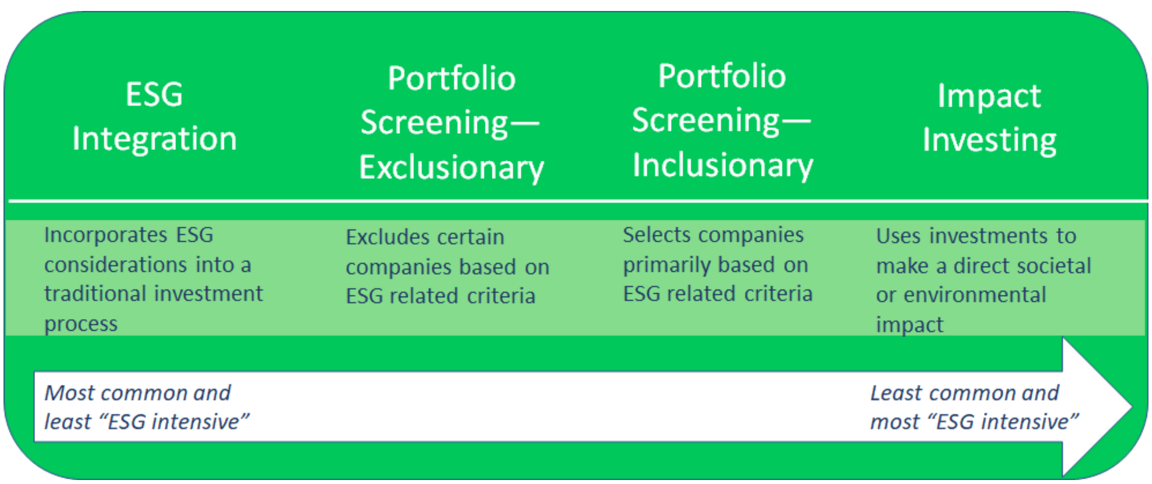
The summer of 2021 was one of the worst on record for fires and hurricanes, putting climate change into the headlines on a regular basis. Climate change is just one of many issues contemplated as part of "ESG investing," perhaps the fastest growing segment of the investment universe. The time seems ripe for an ESG primer.

A good place to start is with E, S & G. E stands for Environmental, S stands for Social, and G stands for Governance. Broadly speaking ESG investing is any kind of investing that is based in some significant way on environmental, social or governance considerations. The table in the insert, courtesy of Vanguard Research, offers a wide range of examples in each category. A quick read highlights one of the challenges of ESG investing; by its very nature it is subjective and no two investors will agree on what factors to include and how they are to be weighed against each other.

The terms socially responsible investing and sustainable investing are still in wide use, but ESG investing has become the standard and most comprehensive investment industry label. The roots of ESG date back at least to John Wesley, founder of Methodism, who urged his 18th century followers to avoid investing in businesses that profit from alcohol, tobacco, weapons, or gambling. ESG in its modern form began to arise in the wake of battles to rid university endowments of apartheid-related investments ("divestment"). Several mutual funds were developed for investors eager to align their investments with their values. It was initially thought that investors might have to accept slightly lower investment returns, but recent research suggests that there may not be a financial cost, and some proponents of ESG investing would argue that it can enhance investment returns. In the meantime, the number of ESG strategies has skyrocketed and everyone seems eager to get on the bandwagon.

As shown below there are four flavors of ESG investing, ranging from the most common, ESG Integration, to the least common, Impact Investing. ESG Integration means that a strategy takes ESG factors into consideration as a part of its investment process. Most actively managed mutual funds—and before long it may be the vast majority—seem to claim some level of ESG integration. The basic idea is that scoring poorly on ESG factors constitutes a risk that should be considered as part of the stock selection process. To put it crudely, dumping toxic chemicals or getting Johnny hooked on cigarettes might be bad for business.

Impact investing lies at the other end of the spectrum. These are very focused investments whose primary intent is to achieve a specific environmental or social good. This tends to be the province of large foundations, who might, as an example, provide seed capital to social ventures that align closely with the mission of the foundation.



With ESG investing becoming ubiquitous--Yes, of course we consider ESG factors in our investment process!--and Impact Investing not generally accessible to ordinary investors, the two flavors of Portfolio Screening are most relevant here. The idea is to measure companies on a variety of factors and either screen out all the companies that rate poorly or screen in companies that rate highly. As the table from Vanguard clearly suggests, the number of possible ESG factors is daunting. Databases have sprung up over the last couple of decades rating companies on a myriad of measures. With many dozens of factors across thousands of public companies and no standardized metrics for any factor, one has to wonder at least a bit about the quality of the data. Further, as ESG strategies become a larger part of the investing universe, the incentives for companies to try to game the system is growing rapidly.[1]

Even putting the issue of data integrity aside, most companies are going to do poorly in some areas and better in others. Does being the leader in financial reporting transparency compensate for generating toxic waste? What if it's only a little toxic waste? There is no escaping the fact that assigning ESG ratings involves a tremendous amount of complexity, ambiguity, and subjectivity.

In addition to being exclusionary or inclusionary, portfolio screening can vary along a number of other dimensions. First, how automated is the process? Exclusionary screening lends itself to passive strategies (those that rely on some sort of broad stock index). For example, a fund might utilize a computerized algorithm that combines a company's score on, let's say, one hundred ESG factors into a single ESG rating. The fund might consist of every stock in the S&P 500 Index except those that fall below some predetermined threshold, with stocks moving in and out on a regular basis as ESG ratings are updated. Other strategies might utilize a similar algorithm but overlay it with qualitative judgments; some of those judgments might be ESG related, while others might be based on prospects for positive investment returns[2].

Perhaps most importantly, any given strategy may look at the full panoply of ESG factors or choose to have a particular focus. The chart on the next page, from the Investment Company Institute, paints a picture of how ESG funds break down based on the types of factors they consider. It may be surprising to discover that a significant percentage of ESG funds are based on religious values, hearkening back to ESG's 18th century roots.

At this point you may be thinking, this is all very interesting but how does this affect how my Lebed Asset Management portfolio is managed? And, should I be investing in one of the 592 funds that invests according to ESG criteria? On the first question, there are two ways in which ESG factors impact your portfolio. First, we have become increasingly sensitive to environmental, social and governance concerns as risk factors (a type of informal ESG integration). We are bottoms-up investors, looking for opportunities to invest in good companies at good prices. But risk is always a big part of that equation and the more that ESG investing has put a spotlight on various issues, the

---

[1] In this vein, bogus efforts to improve a company's environmental image have spawned the term "greenwashing."

[2] This is as good a place as any to note that many of the original pioneers of ESG investing, who tend to retain the term socially responsible investing, engage in shareholder activism, using their influence to push company boards and management to become better corporate citizens. Arguably these funds best capture the real spirit of ESG investing.

more sensitive we have become to these considerations as part of our risk assessment. Just by way of example, we became concerned at the time of the 2015 Paris Climate Accords that a potential transition away from fossil fuels created a major risk for oil and gas producers. We haven't owned one since that time. This wasn't a moral judgment, and at a low enough share price we would reverse course. But we do take this kind of consideration seriously. In addition, a handful of clients have asked us to avoid certain types of companies on ESG grounds and we are always happy to accommodate that conversation.

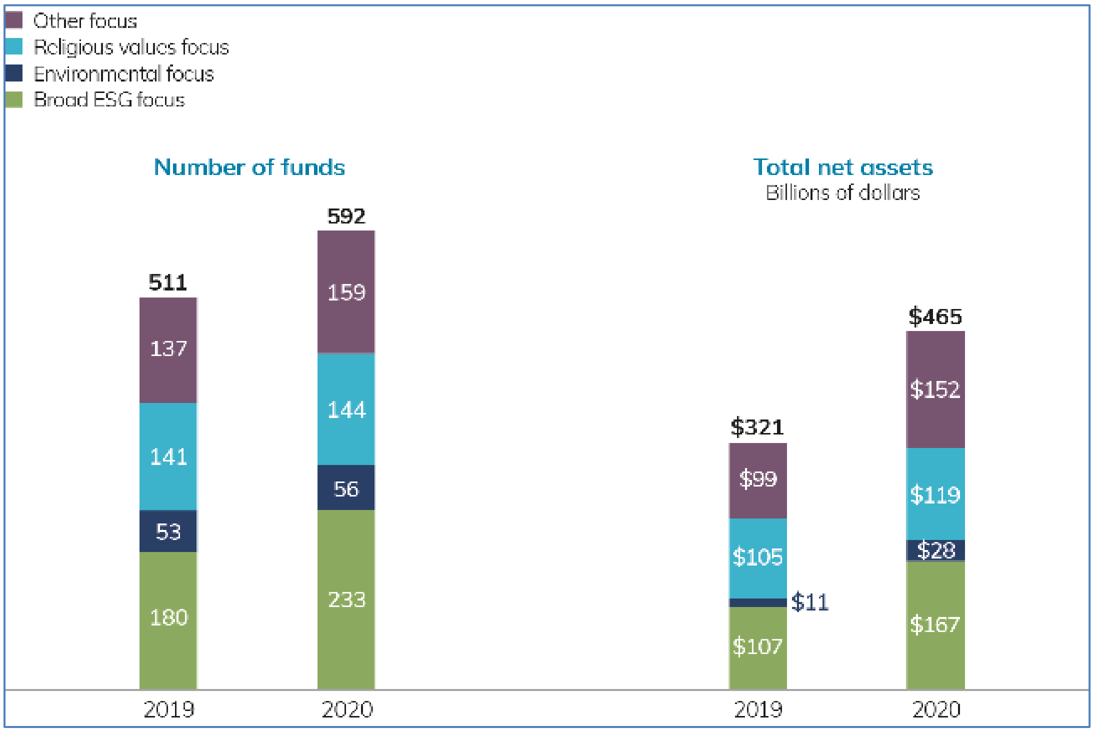


Chart reprinted from the Investment Company Institute's 2021 Investment Company Factbook.

As to whether we would advise you to invest in ESG strategies, the good news is that in aggregate these strategies seem to deliver reasonable returns. On the other hand, we would go back to the issue of complexity, ambiguity, and subjectivity. Whatever values you might ideally want reflected in your investments, no matter how carefully you (or anyone else) were to examine a particular fund's process, including all the ESG factors incorporated and how they are balanced against each other, you would be hard pressed to say with confidence how well those values are reflected in the fund. Whether you can tolerate that kind of ambiguity may be the most important consideration.

October 12, 2021
Boston, MA

Examples of Factors used in ESG Investing

Environmental	Air emissions and air quality	Fossil fuels	Occupational health and safety
	Biodiversity protection	Hazardous materials use	Renewable energy sources
	Community health, safety, and security	Land contamination	Waste generation
	Energy conservation	Natural resource preservation	Water use and conservation
Social	Adequate housing	Consumer privacy	Opioids
	Abortion providers	Employment of minorities and women	Religious values
	Adult entertainment	Human rights standards	Tobacco
	Alcohol	Income inequality	Union relationships
	Animal testing	Manufacturers of birth control products	Weapons
	Casinos and gambling equipment	Obesity	Workforce exploitation
Governance	Antitrust violations	Consumer fraud	Political contributions
	Auditor independence	Disclosure of material risks	Reporting transparency
	Board independence and elections	Executive compensation	Short-term focus
	Board diversity	Oversight of strategy	Voting rights

Table reprinted from:

Vanguard Research, "ESG, SRI and impact investing: A Primer for Decision Making, August 2018."