Trust Company *of* Vermont Quarterly Update

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Brattleboro ◆ Burlington ◆ Rutland ◆ Manchester ◆ St. Albans

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Sports Illustrated may have saved my soul, and my portfolio

Jack Davidson

The Catalyst: It was 1987. I had not yet entered middle age, based on the definition at the time, but it was on the horizon. My focus was to save enough money to pay for the college costs for my two sons, without incurring significant debt. My wife decided to work part time as a therapist in order to balance her life as a stay-at-home Mom, and to increase the family income. On occasion, she also expressed the challenges of raising three boys, and I would often suggest that her definition of "boys" should not include me on her list.

I don't think I spent much time on introspection or pondering my contributions to society. Rather, I focused on work, home, and playing a sport. I don't recall reading about sports. Although one son read Shakespeare, he was eclectic in his reading choices, as was my other son. On occasion, I simply started reading their preferred list of books and periodicals, except for Shakespeare. Shakespeare was a second language for me and I do not do well with second languages. The eclectic list included "Sports Illustrated", which employs my language of choice.

It was November, and the Sports Illustrated edition of November 16, 1987 arrived at the door. I scanned through the pages. All went well until page 78.

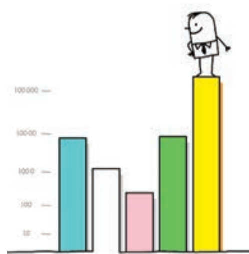
I encountered an article by Robert H. Boyle titled "Forecast for Disaster". This article was well-researched, and painted a picture of the damage our industrial world was doing to our planet, if we did not address the issues sooner than later. I was planning for my sons' future. I had not been planning for their sons and daughters. My life was about to change. It would become more complicated.

The journey into Socially Responsible Investing (SRI)

Although my journey may have started in the mid 80s, when I was approached by an individual who wanted a screen to eliminate companies investing in South Africa, the catalyst was the impact of global warming. What follows spans the winds of time and, perhaps sensitive to the weather, my suggestion to most readers is simply to "puddle jump" to page 5 and avoid my long-winded explanation of our journey through time succinctly expressed by our managers in "From SRI to ESG at TCV".

As a result of the unanticipated shift in focus, in 1988 I started a Socially Responsible Common Trust Fund (CTF) while working for the Trust Department at Vermont National Bank. A CTF operates much like a mutual fund, but is regulated in this case by the Office of the Controller of Currency rather than the Securities and Exchange Commission (SEC). Although investors could only go in and out of the CTF fund on a monthly basis, the CTF behaved very much like a mutual fund, but without significant overhead. Maintaining a mutual fund is very expensive. Recently, Fidelity shifted billions of dollars from mutual funds into common trust funds to save significant costs of regulation by the SEC.

Bank examiners seemed glad to journey once a year from Boston to Vermont and my examinations were more fun than pain for me. The trust examiners understood that trust departments in banks were a sub-culture, and they offered emotional support. Perhaps it is unfair to "bankers" for me to even try to explain the two worlds that inhabited the headquarters at 100 Main Street in Brattleboro. My view was uncomplicated. Bankers look for spreads (the difference between what they borrow and what they loan). Trust staff look to grow a portfolio of stocks and bonds for their clients, and take a small slice of the returns, subject to the ebb and flow of the market, with the intention of maintaining long-term relationships.

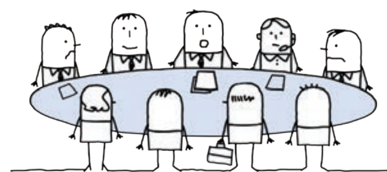


During the process of designing the SRI common trust fund, I was very fortunate to have members in the community who were familiar with this world of SRI. One of my advisors sought out the head of the Bank, who saw the wisdom of this new world of investing. As I was creating my product, the bankers were creating their own. Their product was better than mine.

The Socially Responsible Banking (SRB) program was introduced in 1989. The objective of the program was to allow depositors to have their deposits used locally for community investment and non-profits, such as "affordable housing projects, conservation and agricultural groups, downtown revitalization and community building programs, educational initiatives, and business and economic development projects".

I decided not to promote the Trust Department's SRI Fund, simply because I was competing for deposits that could help local businesses and non-profits. In the trust world, we export money out of town. We buy stocks, and unless a closely-held stock of a Vermont company is on our list of approved investments, money will not flow into Vermont.

Both programs encountered some resistance within the Bank. The depositors that selected the SRB Fund by depositing money in a CD as part of this program, expected their deposit to be invested based on the criteria of the program, which included non-profits, but some of the loan officers were reluctant to loan to non-profits, on the theory that during bad times they might not have the skills of business owners. At one point approximately 50% of the deposits designated to this program were kept in short-term government bonds, rather than loaned locally. Fortunately, the bankers brought in a loan officer familiar with this type of program, and when the recession of the early 90s hit hard, his loan default was too small to measure, in contrast to the other loans made outside the program. Over the years, the program became very attractive to bankers and depositors. When Chittenden Bank bought Vermont National Bank in 1999, they kept this program and closed down



the Trust Department's SRI Fund. The SRB program is still in existence and promoted by Peoples United Bank.

When I created the SRI Fund, I employed an outside manager skilled in SRI to manage the assets. This manager used the fund for his clients, so it was operational and well-funded. It may have been one of the first SRI funds in the country.

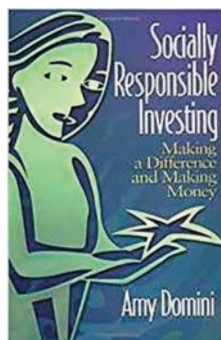
As I write this journal, it would be comforting to say "we" rather than "I". For example, "When *we* created the SRI Fund" evokes collaboration, and feels comfortable, rather than "When *I* created the SRI Fund". Unfortunately, I did not have "we's". Was I prescient? No, I was premature! When I asked my investment managers

to consider using this program, they resisted, and did not promote the fund to clients that might find it attractive. Why thought I?

The first mistake may have been the catch phrase prevalent at the time, "Socially Responsible", which was offensive to some people. In this field of investment, the name started to change. Over time, I changed the name to "Socially Aware", and others to "Socially Conscious" or "Sustainable Investing". I had wandered into the dangerous world of the contrapositives. So to those who do not invest this way, I apologize. You are not "Socially Irresponsible" if you are not inclined to invest in this way.

Our goal then and now, was to invest long term for our clients. In the formative years of SRI, the prevailing sentiment seemed to be that those who invested in SRI funds would achieve less of a return, as the price for investing in a socially responsible way. Our managers would not embrace this approach for this very simple reason.

In the early stages of my journey towards, hopefully, heaven, I was fortunate to meet three people who were at the forefront of this movement:



Peter Kinder, Steve Lydenberg, and Amy Domini. Our contact was infrequent, and my undocumented memory certainly had an impact on me when, for example, Amy Domini said that social investing would result in less return as the price to pay to invest with values.

In May of 1990, *Kinder, Lydenberg, Domini* & Co. (KLD) created the Domini 400 Social Index Fund. My hope was that over time this index would support a way to invest that did not detract from yield, and would attract managers to the SRI Fund.

In 1999, when I became a member of the Trust Company of Vermont, our managers were not eager to restart the SRI Fund. Instead, we simply encouraged awareness, and the ability to communicate to our clients that we will manage around their values, and we continued to monitor portfolios using a program developed by KLD.

KLD's on-line Social Investment Database Service provided 24-hour computer access to data and analyses on the social records of over 800 publicly traded corporations. The 800 corporations

consist of 700 large companies, and 100 smaller companies with outstanding social stories.

Each KLD review covers a company's strengths and failings in nine major social areas:

- *the environment*
- *military contracting*
- *employee relations*
- *community involvement*
- *quality programs*
- *excessive compensation of executives*
- *diversity*
- *nuclear power*
- *product safety*

Perhaps the two most important components of long-term investing is staying on course and investing in companies that will achieve success long term, rather than over shorter periods of time.

When Warren Buffet, the oracle of the stock market, suggested the following for the benefit of his wife and heirs, *"Put 10% of the cash in short-term government bonds and 90% in a very low-cost S&P 500 index fund"*, the advice was to his trust officer. Trust officers often can save a portfolio long term, when heirs have short-term concerns. Our trust officers have seen too many instances of investors buying when the market is up, and selling when the market is down, and incurring significant losses regardless of the assets that comprised the portfolio.

But what about outperforming the S&P 500 Index? Would SRI investing jeopardize our goal of outperforming the S&P 500 Index?

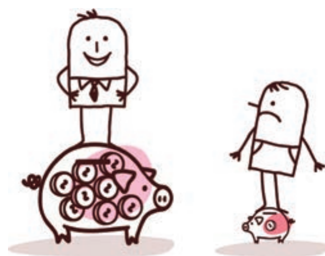
When Amy Domini planted the thesis that you would not do as well with SRI, it was at the time she created the Domini 400 Social Index Fund. But, of course, time will tell. And so far, time suggests that the prevailing analysis of SRI investing is not a trade-off of performance, while incorporating values. Rather, long-term investing and values may create better choices.

SRI and Amy Domini 25 years later

May 2015 issue of "MarketWatch:[1] "The question of whether an investor will sacrifice returns by doing good is a question that will always be asked", says Domini, even though times have changed. When she started the Domini 400 in 1989, to track socially responsible companies, performance lagged behind the S&P 500 Index by -0.22%. But since 1990, the social index (MSCI KLD 400) returned an average annual total return of 10.46% compared with the S&P 500's 9.93%.

Now to be fair to Warren Buffett, Amy was citing her index and not an SRI fund. An SRI fund's costs, and other factors, may end up with a return that may be less than a very low cost S&P 500 index fund.

When I was first introduced to the 9 factors utilized by KLD, one would have thought that I would focus on the environment. Oddly, I was drawn first to *excessive compensation of executives.* Making long-term decisions seemed more complex than I initially thought, and my shortcut was to find companies where the CEO looked out for the shareholders, employees, and customers, as well as the product or service.



Those driven to do what's best for the company, rather than their compensation, in a world dominated by CEO incentives that reward short-term performance, may be the best managers of the companies to buy long term. My hope is that they may help us to avoid Boyles's "Forecast for Disaster".

Our managers have integrated many of the principles that are fundamental to the world embraced by Peter, Steve and Amy. So,

I am now relying on our managers to help me arrive in heaven, as well as saving my portfolio. I am also hopeful that twenty years from now I will be going to the same beach, the same location, with the same SPF 30 sun screen........ accompanied by my Sports Illustrated.

"Sure, we need more research in alchemy, necromancy, and sorcery, but where is the money going to come from?"

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Endnote

[1] 'Socially responsible' investing has beaten the S&P 500 for decades, May 26, 2015 - Jennifer Openshaw

From SRI to ESG at TCV

TCV Investment Committee

The members of the TCV Investment Committee have watched with interest the evolution of socially responsible investing (SRI) over our careers. It's encouraging to all of us that in the most fundamental of ways, the worldwide effort of caring about what the companies that we own do, and how they do it, seems to have evolved to where we as investment managers have tried to be all along.

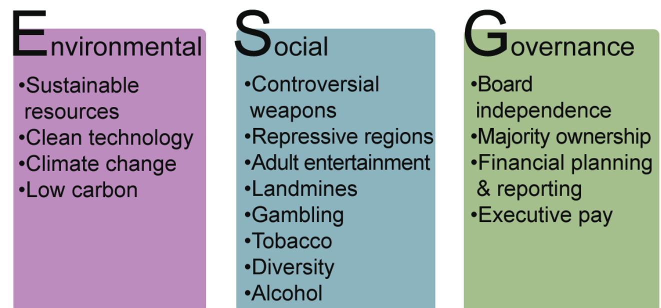
Most of us began our careers when the basics of SRI were all about exclusions. You, as a portfolio manager, tried to avoid companies, industries or specifics that the portfolio's owner found offensive. It was, and still is, fairly easy to be exclusionary, especially when you are dealing with an investment process that stresses individualized portfolio management, as we do. Was the client opposed to apartheid and didn't want to own companies that operate in South Africa?......Keep those companies off their buy list. A portfolio holder doesn't want to own weapons manufacturers?...........Easy, sell those defense companies out of the portfolio. It was relatively easy to avoid the obvious outliers, but as we learned, it wasn't always as clear as we thought. Many of us had clients who wanted to avoid tobacco companies; it probably was (and still is) the number one industry most clients want to avoid. Yet we remember in the late 1990s when the Sara Lee Corporation announced that they were SELLING their tobacco unit! We thought Sara Lee only sold frozen pound cakes and deli meats; we didn't even know about their tobacco unit! Clearly work needed to be done on corporate discoveries and disclosures, and thankfully since that time, those areas have improved tremendously.

As the new century began, SRI was also evolving to becoming more proactive. The goal was to think positively about what you owned and try to own the good, as opposed to just not owning the bad. We hoped to try and benefit from companies that were acting in a more thoughtful and principled manner.

To all of us, this of course makes perfect sense, and this, in many ways, is what we have tried to do all along; own and reap the long-term benefits of companies that make products and provide services that people like. If they do it in a proper way, then shouldn't they prosper as well? There was more and more information available about how companies behaved; how they treated their employees and what their environmental practices and corporate behaviors were. Still, while the information and disclosures about such corporate behaviors were improving, it's harder to be inclusionary and still try and meet the overall portfolios goals and objectives of capital preservation, income, and growth.

Also, many industries that seemed to possess the characteristics that numerous clients were looking for didn't (and still don't) have investment grade opportunities. Even 15 years ago, many of us had clients that wanted to invest in solar companies to benefit from the perceived potential growth of a new industry. Unfortunately, especially then, there weren't many viable alternatives. To meet that goal some portfolios invested in what was reportedly the corporate owner of the largest solar operation in the world, British Petroleum. In fact, at that time the company started using their green and yellow "sun" logo with the tagline BP: Beyond Petroleum. Sadly, we know how that turned out, and BP ended up selling their solar operations to help pay for the monetary damages stemming from the Gulf of Mexico oil well disaster. Again, inclusionary is harder.

Now, the investing world seems to be evolving towards an ESG (environmental, social and governance) mindset, which, in simple terms, is where we on the TCV Investment Committee have tried to be all along. We have always believed in a long-term approach to owning companies and building portfolios. It's obvious to us that companies that behave properly with respect to environmental, social and governance issues possess more of the characteristics for potential longer term success. When you own shares of a company, you are essentially (but not legally) in a partnership with the managers of that company; of course, longer-term proper stewardship is in everyone's best interest. Those with good stewardship are the companies that we seek to own, and the types of management we seek to "partner" with.



The growth of both corporate disclosures in general and the efforts of so many companies to become better stewards is making this easier. In fact, at the present time we are evaluating new providers of ESG data and research services, and hope to have it integrated into our investment process by the fall. Most importantly, as we work towards these goals we want to readily acknowledge that we know that no company or investment process is perfect, that mistakes will be made by the companies we hold, their managers, and, of course, by us. However, as George Will said *"the pursuit of perfection often impedes improvement"*, and the continuous improvement of this process is what we strive for.

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