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Opinion

Advisors Can Soar or Sink with Mission-Based Investing

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Growing investor demand for mission-based investing – focusing on socially responsible investments that adhere to a set of standards or beliefs – represents an opportunity for advisors and asset managers looking to grow their business.

Diversification within such social impact investing is not achieved simply by dropping a socially responsible investing (SRI) product or a strategy based on environmental, social and governance (ESG) criteria into a high-net-worth client's portfolio. Managers that communicate effectively about SRI and ESG have an opportunity to build deeper relationships with advisors who strive to convey the potential benefits of mission-based investing to their clients and how these investments can best be positioned in their portfolio.

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A decade ago, the concept of mission-based investing was new to the wealth and institutional asset management industries. Most participating clients were inclined to ask for an investment that would enable them to address a narrow societal or environmental issue.

Fast forward to the present day and this dynamic has hardly changed among investors who wish to engage in such social impact investing for the first time. Most approach the world of mission-based investing with one issue they are passionate about. It is rare for an investor to express interest in a portfolio that combines, say, directed community lending, sustainable water initiatives, timber conservation and urban renewal all at once.

If mission-based investing is to become a long-term strategy in high-net-worth client portfolios, then advisors must follow up standard discussions about overall financial goals, philanthropic values and particular ESG interests with another key discussion: how best to diversify these kinds of investments in a portfolio. For that, they can look to the managers they work with for insight.

For example, assume that the client is concerned first and foremost with advancing alternative energy. Although that is the client's passion, alternative energy can be a volatile area of investment. A thoughtful advisor should identify other areas for investment that tackle the same problem. In this instance, a company that makes energy-efficient appliances or real estate that focuses on zero-net buildings might act as a diversifier.

The advisor should also identify the client's secondary social benefit interests, such as water purification, efficient waste disposal and organic fertilizer use. This allows for the construction of a risk-mitigating core/satellite approach, whereby energy is the core and the other issues act as satellites.

It can be helpful to take this approach one step further, especially if a client's secondary passions do not provide sufficient diversification. Additionally, managers should be prepared to suggest other social benefit investments that might help advisors' clients to broaden their criteria.

A client who is passionate about organic farmland might also be interested in an insulation company that outfits trucks transporting organic vegetables to reduce spoilage. Perhaps they would be open to investments even more varied, such as sustainably managed timberlands, education bonds or foreclosure-abatement initiatives. The only way for an advisor to know is to scour the universe for mission-based investing opportunities and have meaningful conversations about them with managers and their clients. These create opportunities to further diversify clients' portfolios.

Solar energy provides an instructive example of why this tendency to focus on a single social benefit segment can be excessively risky. Five years ago, the solar energy industry saw a surge of interest among social benefit-minded investors.

In some instances, advisors gave clients exactly what they requested. Hundreds of millions of client dollars were directed into mutual funds, exchange-traded funds, separately managed accounts and private equity funds focused on the solar industry.

Although 2013 was a favorable year for solar energy stocks, the longer-term results have been far less auspicious. In the three-year period through October 11, 2013, two of the leading solar ETFs returned -51.63% and -59.84%, respectively. The comparable five-year periods are worse, according to ETF Database.

It is no wonder that wealthy individuals who invested in solar energy three to five years ago are often unenthused when we seek to gauge their interest in mission-based investing. Wealth advisors and managers have to avoid concentrating clients' social impact investments simply because a client expresses an interest in just one or two societal or environmental themes. As with any investment, diversification is essential.

Any one fund, however broadly diversified, still carries all the underperformance risk inherent in a single strategy, sector or manager. For investors in the upper tier of wealth, checking off the mission-based investing box with a single fund is tantamount to using one municipal bond to provide tax-exempt fixed income exposure.

Our experience with mission-based investing based on environmental, social and governance criteria has led us to advocate for a rigorously diversified approach to building a social impact portfolio. A wider palette of socially responsible investment strategies can provide high-net-worth clients with market-comparable returns, promote better risk management and expand a client's ESG horizons. It is an area that advisors and managers can overlook only at the risk of missing out on opportunities to grow their business.