

THE MYTH OF THE MARLBORO MAN

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Annual Past Performance to 31 December Each Year

	2015	2016	2017	2018	2019
Positive Change Composite Net (%)	n/a	n/a	n/a	6.0	25.1
MSCI ACWI	n/a	n/a	n/a	-3.3	22.4

Source: Baillie Gifford & Co. US Dollars. Changes in the investment strategies, contributions or withdrawals may materially alter the performance and results of the portfolio. Please note as the strategy's launch date was 31 January 2017, full historic performance is not available.



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THE MYTH OF THE MARLBORO MAN

*Quitting tobacco and fossil fuels should no longer
carry a wealth warning, writes Scott Nisbet*

It's 12.04am Pacific Time on 24 March, 1989. In the pitch black frozen night, a crackling radio transmission breaks the silence in the control room of the Alaskan coast guard:

“Uh... Valdez here... We've... we've fetched up hard aground... uh... North of Goose Island”

Joseph Hazelwood, the captain of the super tanker Exxon Valdez, speaks very slowly, words slurred¹, with little sense of urgency. Yet 100 feet below him, 10.8 million gallons of crude oil are gushing into the coastal wildlife sanctuary of Northern Alaska, creating a man-made disaster of unprecedented scale, which will cost \$2.5 billion to clear up.

¹Listen to it here https://www.youtube.com/watch?v=1XNwjdI5m_E
Hazelwood was later cleared of being drunk as his shipmates all said they hadn't seen him drinking that night. See what you think.

The financial equivalent of a cigarette packet health warning, but for your wealth.

But it was no disaster to be a long-term shareholder in Exxon Mobil. Quite the opposite in fact. From 1926 to 2016 Exxon created more value than any other company in the history of stock markets – US\$1.002 trillion (over and above the return from one-month Treasury bills) to be precise².

Now pan across to the instantly recognisable figure of Yul Brynner: the leader of The Magnificent Seven, the coolest cowboy, a perfect Marlboro Man, The King and I later breaking all Broadway records – shall we dance? – and lifelong smoker. On 20 February 1986, months after his death, his last TV interview was released as a 30 second anti-smoking advert. Rasping and gravelly, riddled with lung cancer, famous bald head in black polo neck, he eyes the camera:

“Now that I’m gone, don’t smoke. Now that I’m gone I tell you, kids, whatever you do, don’t smoke”.

Don’t smoke yourself for sure, but do own the shares. Not too far behind Exxon, Philip Morris was the sixth largest contributor to equity wealth generation in America 1926 to 2016. \$470 billion of alpha over 90 years³. Ka-ching.

They have a lot to answer for, these oil and tobacco giants. But not in the humanistic, moral-compass way you might assume. No, the crux today is that their huge financial success of yesteryear sustains a widely-held perception even today – especially in America – that “you can invest only in do-gooding companies if you like, but you will be giving up returns to do so. And my fiduciary duty is returns!”. The financial equivalent of a cigarette packet health warning, but for your wealth.

The purpose of this paper is to prompt you to wonder if this perception is not only out of date, but that it is actually perverse; that the ‘return concession perception’ is as passé as high-tar smokes or oil-fired stoves, and that much better returns are already coming from the other end of the investment spectrum i.e. companies that contribute positively to society.



Yul Brynner in *The Magnificent Seven*
© United Artists/Kobal/Shutterstock.

²Bessembinder, H. *Do Stocks Outperform Treasury Bills?* Arizona State University. May 2018. P25. https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2900447

³Same Bessembinder study as footnote 2



*Don't smoke...
but do own
the shares*

But it takes a lot to overturn a long and widely held belief across a system – we'll call it The Myth of Marlboro Man – so where to begin?

At this point the author usually starts citing a flurry of academic papers to back up their argument. This isn't that helpful as there are thousands of papers on this subject. You can always find a few to suit the argument and Hey Presto, '*quod erat demonstrandum!*' Except that the readers glaze over as multiple links to lengthy studies of regression analysis are brandished.

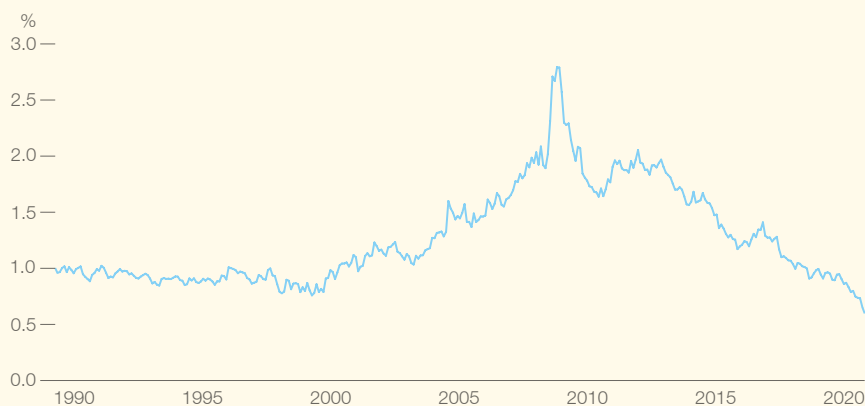
So, we will keep links to worthy studies out of the main narrative here. This does not purport to be an academic paper. It is an opinionated thought-piece with first-hand back up. For we can make our point by a more convincing method – our own first-hand experience of adding alpha running money 1. In a fund that doesn't touch these exclusion sectors and 2. In another that goes further and actively seeks change for good.

FOMO SCHMOMO

The first thing to address is the fear of ‘missing out’. This is, in fact, misplaced. Indeed, thinking of ESG investing as exclusion investing is itself out of date. But even with this old and blunt exclusionary definition we can start debunking the Myth of the Marlboro Man.

Over the long run Exxon Mobil and Philip Morris have been the stars of the bigger sectors and emblematic of what the exclusion investor might miss out on⁴. How have they really done? What are their prospects?

Peak Exxon has passed



Source: Datastream: Exxon Mobil RI to S&P 500 Composite Index.

In the past the underperforming manager with fossil and tobacco exclusions could rue the ascent of Exxon and Philip Morris. Indeed, Exxon added more market value than any other global company in the 90-year period from 1926 to 2016. But those days are long gone. Exxon has been clearly underperforming for more than a decade now.

It remains a massive and profitable company but one that has entered a long run off period – the shareholder will clip some decent dividends along the way, but it will not grow.

With the cost of renewables falling 10 to 15 per cent. worldwide, the rapid electrification of transport, the ubiquitous consciousness of climate change, Exxon is extremely likely to continue underperforming. The best chance for Exxon to grow in the future would be a huge push into turbines, solar, carbon capture; but this super tanker’s not for turning⁵ – just as the automotive behemoths lost years sneering at Tesla, and Kodak invented the digital camera and buried it.

6 ⁴The other sectors are very small and we will leave them to one side.

⁵“On my first day last week protesters forced us to shut down our headquarters and they are not the only ones who believe we are out of step with society. Some investors do as well, and some of our own staff also, and that’s an uncomfortable place to be. Let me be very clear today that I get it. The world does have a carbon budget, it is finite, and it is running out fast. And we need a rapid transition to net zero.” BP CEO Bernard Looney, February 2020.

Does this sound like a future winner to you?

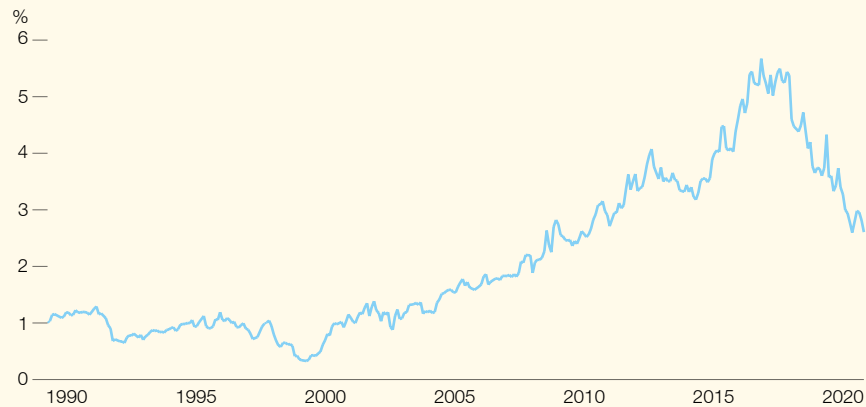
It's a similar picture with Philip Morris (now Altria), the world's largest tobacco company. The underperformance has only spanned the past five years, but its bullet-proof reputation for churning out returns is past its sell-by date.

The lack of growth in recent years is obvious, with cigarette volumes falling 4 per cent p.a. as the number of people happy to encourage lung cancer diminishes by the year. Vaping to the rescue? It's undoubtedly less harmful than smoking, and more harmful than the companies are letting on. (Why would you trust them this time?) Vaping may slow the decline, but for Big Tobacco, just as for their best customers, the Reaper awaits.

So stage 1 – it is hard to make the case that exclusions will remotely harm returns even of the less active managers in future years. And the fortunes of all exclusion stocks will be totally irrelevant to truly active managers.

For stage 2 of our argument today is quite simple: if you are a truly active manager, all that matters is what you own.

Philip Morris.



Source: Datastream. Altria Group share price RI to S&P Composite Index.

YOU ARE WHAT YOU OWN

- This is where another fallacy has retained mileage. Several years ago, CalPERS (California Public Employees' Retirement Scheme) said its no sin restriction had cost it \$3 billion⁶. This is only true if 1. These sectors outperform (which they don't anymore) and 2. You own thousands of stocks in every sector except these i.e. you become a giant index fund.
- Investors are supposed to be forward looking, so the question clients should be asking is this: given most of the market return in the next 10–20 years will come from a small number of exceptional growth companies, do I have enough in them? How much of my capital is wasted in moribund sectors? How is that 'risk reducing'?
- The truth is that hardly any companies matter. We have often cited the work of Hendrik Bessembinder which shows 4 per cent of companies accounted for all the gains in the S&P 500 over 90 years to 2016, and indeed Exxon and other oil companies and Philip Morris were very prominent contributors for decades. But they are slipping down the rankings now – since the study was first published Apple, Amazon, and Alphabet have all overtaken Exxon on the all-time list.
- If you run a 50-stock global portfolio, or a 30 stock one, or a 70 stock one, with commitment to your favourite ideas, then all that matters is how these individual companies do. Only for managers who have hundreds of tiny positions – the insipid diet coke version of 'active' – does it matter how non-holdings do?



The truth is that hardly any companies matter.

SHOW ME THE MONEY



Tom Cruise in Jerry Maguire.
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NOTHING OUTSIDE THE PORTFOLIO MATTERS.

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Enough pontificating though. How have we done for clients in the relevant arena? Would Jerry Maguire’s “Show-me-the-money!” client, Cuba Gooding Junior, keep us on?

We have two very relevant test cases – one can be considered an ‘exclusion’ portfolio and the other an ‘impact’ portfolio.

We have been running a 10 stock global equities portfolio called Global Outliers for 11 years for an institutional client. The portfolio only has a couple of rules it must adhere to: a maximum of 10 stocks, no more than 50 per cent of the portfolio in one stock, and no tobacco, oil and gas, or the other standard sin sectors. So standard exclusions, no impact or social good measurement, but a very very concentrated best ideas portfolio. The portfolio has returned 20 per cent p.a. over 11 years versus 10 per cent p.a. for MSCI ACWI.

This is not beating the index; it is a complete annihilation of it. Nothing outside the portfolio matters. If you own seven stocks (the average number of holdings over 11 years) then all that matters is how they do. The impact each of them has on the portfolio return is hundreds of times what any stock in the index could possibly have. In fact, all that matters is for a couple of your seven stocks to be ‘home runs’, not even all seven stocks matter that much!

I said we call this our ‘Global Outliers’ strategy, but you won’t have heard of it. We run Global Outliers for a couple of clients who asked us to do something super-concentrated, but we have not made it available as most institutions would want to add other ‘risk parameters’, rebalance after outperformance, and generally dilute the purity of the strategy and hence the returns. We prefer to keep it as a pure test case, but with real client money, of what the most unfettered active management can achieve.

BEYOND EXCLUSIONS

Good ESG investing has moved on from ‘avoiding bad’. It is really about ‘backing good’, as these companies have a great chance of growing and producing high returns. This is what our Positive Change strategy tries to do. Although it’s early days the three year track record is at the very least a promising start: 24.7 per cent p.a. versus 9.9 per cent p.a. for global equities⁷.

Positive Change is full of companies such as Discovery: a health insurance company that offers lower premiums if customers meet fitness targets. The customers get healthier, they pay lower premiums, and Discovery makes higher profits for shareholders since claim rates become so low. We can make a similar case for Kingspan (the best loft insulation), or Tesla, or Danish energy provider Ørsted. What’s not to like?

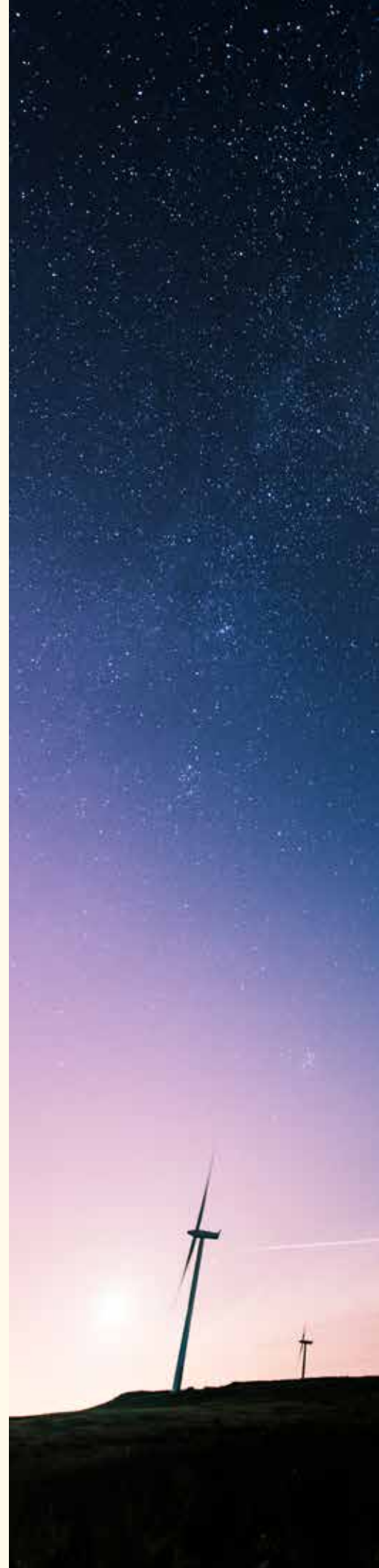
But beyond our Positive Change Fund evidence is accumulating that this kind of investing works. Generation has a 12-year track record that is excellent – 12 years is too long a time period to be luck or fashion. The Fortune ‘Change the World’ list of 2015 has outperformed handsomely (75.7 per cent versus 53.4 per cent over five years)⁸. In the meantime, the famous Vice fund (once called the Barrier Fund; its largest holding remains Altria) is miles behind the S&P 500 over three years (7.7 per cent p.a. versus 13.3 per cent p.a.), considerably behind over five years (7.0 per cent p.a. versus 9.8 per cent p.a.) and even lagging over 10 years now (11.5 per cent versus 12 per cent).

Which leads us to believe that Positive Change – a portfolio of companies that produce a positive impact – will continue to do well⁹. After three years, ‘promising start’ seems fair to modest. This has very serious implications for the often cited ‘fiduciary duty’ of returns only. There are big sectors in the current indices that will be extinct within 20 years. By neglecting to recognise this are they neglecting the real fiduciary duty?

⁷Past performance is not a guide to future returns. Changes in investment strategies, contributions or withdrawals may materially alter the performance, strategy and results of the portfolio.

⁸<https://fortune.com/change-the-world/2015/>. Cumulative return since 1 Jan 2015. Assumes an equally weighted portfolio.

⁹For more evidence of an academic nature look at the work of Michael Porter but I’d rather not be prescriptive on it here.



THE BASELINE

One omission when the returns of ESG type funds are cited is a sense of the baseline. It is, as Meghan Trainor catchily sang, (almost) all about the base.

Different numbers are quoted about how well the the active management industry does as a whole – US large-cap managers have done horribly against their index over 10 years; UK managers have done better versus the FTSE 100. But when you look across the piece at unrestricted global equity managers roughly two thirds underperform in the long run after fees. No one is hiring the whole active management industry, and there are easy ways to improve your chances through simple selection criteria for managers. Nonetheless, such overall statistics have had a big influence on how pension plans in recent years have gravitated towards passive.

So, when it comes to assessing active ESG funds and whether they concede any returns, this baseline – two thirds of ‘normal’ actively underperform – has to be kept in mind – but usually it isn’t. If you see a headline ‘Only 45 per cent of ESG funds outperform global equities’ then our interpretation of this number should be the opposite of the headline implication. 45 per cent beats 33 per cent so in fact the average active ESG fund is doing better in returns than normal active funds. In future, if you hear that ‘only X per cent of exclusion/impact/ESG focused US large-cap managers have outperformed in the last decade’, remember the relevant baseline then reappraise.

A FIDUCIARY IRONY

We've got this far without quoting multiple studies. I will limit academia referencing to one paper often cited in America, by the Center for Retirement Research at Boston College *New Developments in Social Investing Public Pensions*. Munnell and Chen, November 2016. This starts from the old assumption of exclusion equals return concession, which we have shown no longer to be the case. While the paper notes that the most recent US Department of Labor bulletin (2015) softens the fiduciary stance, saying ESG factors that 'directly affect the economic returns of an investment' may be incorporated when assessing an investment, its overall message still cautions fiduciaries from getting carried away.

But surely the assumption should be that ESG factors do affect returns directly and indirectly, and you'd better be able to show how you are taking them into account!

One day the wording will catch up. For now, we can see the conundrum it leaves for pension fund committees. It feels like the equivalent of Milton Friedman's 'a company's only purpose is to make profits'. This narrowness has been widely discredited for several reasons – various crises, in particular 2008, have shown that by pursuing this goal alone many companies will actually end up destroying themselves. Second, the last 10 years have shown that the best way to create unprecedented amounts of stock market value is not by pursuing a pure profit maximisation strategy in the first place. Amazon, Facebook, Alibaba and Tesla are powerful examples. Capitalism has moved on (it had to).

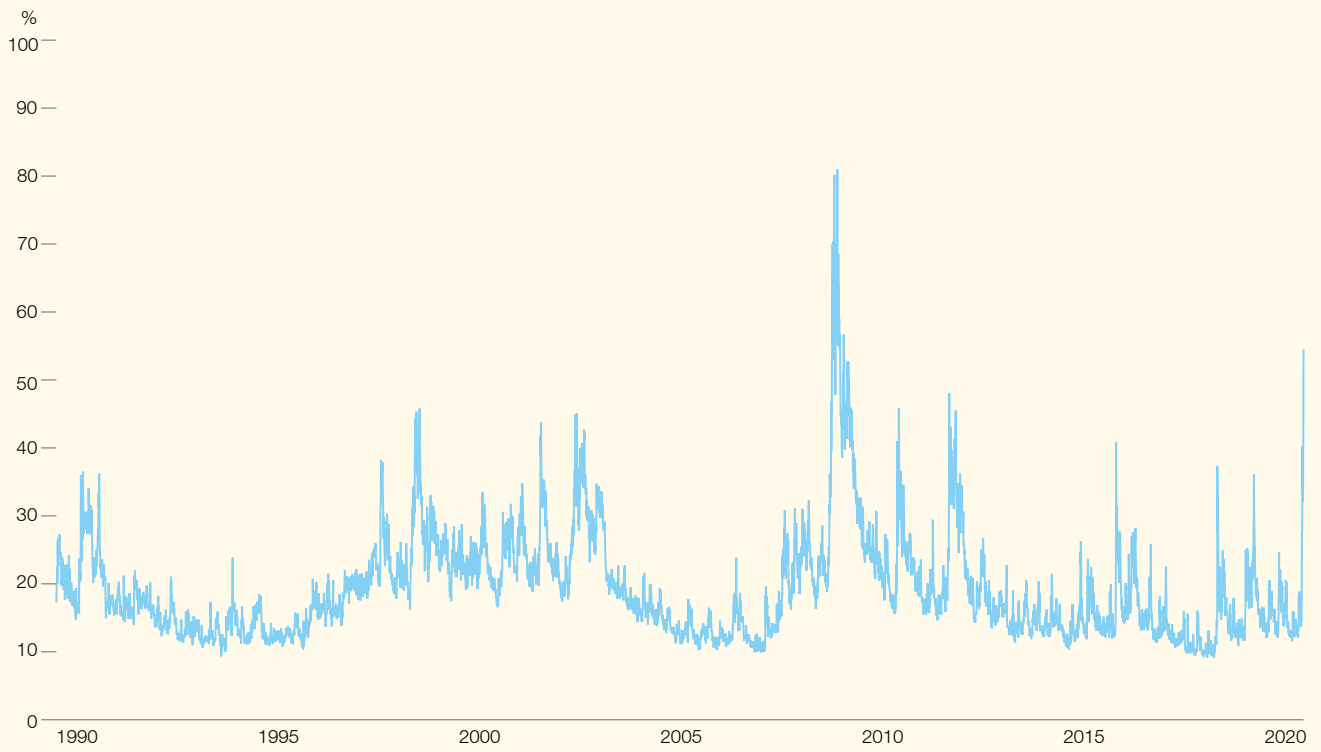
A last thought. Pension fund's fiduciary duty is about returns and the mix of risk and returns. In this vein they have spent huge amounts on 'reducing volatility' by investing in hedge funds (and

alternatives generally) as a result drastically reducing their returns for no comparable reduction in volatility. Hedge funds returned 10.4 per cent net of fees in 2019 versus 31.5 per cent for the S&P 500; the 10-year hedge fund numbers are dire too (4.1 per cent p.a. versus 13.6 p.a. per cent for the S&P¹⁰). Warren Buffett won his 10-year bet of \$1 million with Protégé Partners¹¹ hedge funds very easily. The huge sums paid to reduce volatility that didn't exist in the first place (see below) are the fiduciary calamity of our times. A headlong plunge into hedge funds across the industry, but dare we fund an impact strategy?

¹⁰Based on the returns on the HFRI Fund Weighted Composite Index in USD calculated to end December 2019. Source Bloomberg.

¹¹Buffett's Vanguard index fund returned 7.1% p.a. over 10 years to 31 December 2017 vs Protégé Partners favourite group of hand-picked hedge funds which returned 2.2% p.a.

VIX Volatility Index – Historical Chart



Source: Macrotrends.

CONCLUSION

The perception that ESG based investing concedes return by excluding lucrative profit makers is wrong in a number of ways:

1. The main exclusion companies stopped outperforming a long time ago. They are in inexorable decline. There is nothing to miss out on.
2. Even on the old basis of an ESG portfolio simply being a normal portfolio with certain exclusions, it is only what you own that matters. This is actual investing – the definition of true active investing.
3. ESG investing has moved on. As pro-active seekers of good companies we have an advantage not a handicap, as these are among the companies most likely to grow and outperform.
4. Our own first-hand experience is unequivocal on this: it is only what we have owned that matters, and it is only a small number of growth companies that drive overall returns. Our Global Outliers and our Positive Change strategies are proving this in spades.

Seven men – not quite Yul Brynner’s Magnificent Seven – played Marlboro Man in the billboard adverts from 1954 to 1999. Five of them died of lung cancer, and one of AIDS. The seventh? He was Robert Norris, a real-life cowboy and friend of John Wayne who died aged 90, having never smoked, on 9 November 2019, the day I started writing this paper.

Culturally, time was called on the glamour of Alpha Male Marlboro Man 20 years ago, and yet in the stock market’s eyes Marlboro Man as Alpha Generator lived on, along with his black-gold henchmen.

This thinking is out of date – don’t let it harm your returns. It may be the duty of the captain to go down with the ship, but not for pension funds to cling to the haemorrhaging hull of the Exxon Valdez.



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Scott graduated MA in English Literature and French from the University of Edinburgh and gained a Post Graduate Diploma in Translation from University of Paris. He joined Baillie Gifford in 1996 and worked in the North American and UK investment teams until 2003, when he moved to the Clients Department as a Director with responsibility for overseas clients. Scott became a Partner in 2007 and is a member of our CDMG (Clients Department Management Group). He is also a member of the Strategic Leadership Group.

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