INVESTING

Why Governance Matters In Sustainable Investing

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"When you say sustainable investing, I think of all of these 'green' companies that might be getting a hit with the new presidential administration," Bloomberg reporter Lisa Abramowicz said in response to a comment I'd made on the growth of sustainable investing.

This is a common misconception. Sustainable investing isn't just about environmental issues. It includes three core areas: environmental, social and corporate governance , which are known as ESG.

Many people focus on the 'E' in ESG probably because environmental factors, like reducing emissions or using renewable energy, are easy to understand. But social issues are also important. It may include treating diseases, producing safe products for consumers and creating healthy workplaces for employees.

Corporate governance—the 'G' in ESG—often gets the least attention, but it's another important way that companies can make a positive impact. Good governance seeks to effectively balance the needs of executives and shareholders, which should be good for investors.

What's Good about Governance?

Companies with good governance practices aim to operate in a fair and ethical way. They address issues around pay, including executive compensation, minimum wage and pay equality. These companies usually have policies in place to prevent bribery and avoid corruption.

Well-governed companies also tend to be transparent about their business practices and even how they spend their money. They may disclose their political spending and lobbying, so customers and investors know how the company may be trying to influence legislation.

And these companies also have a clear balance of power. They are overseen by independent and diverse boards of directors. These boards work to uphold the rights of the company's shareholders, and they seek to help the firm's managers identify potential risks and opportunities.

Governance is directly connected to environmental and social factors (hence the ESG acronym). Consider a pharmaceutical company, for example. It seeks to find new treatments for disease, so it has a clear social good. But if the company doesn't have strong corporate oversight of its safety procedures, its products could really hurt people. And that would be very bad for the business—and its shareholders.

Good Governance can be a Good Investment

Most people don't have the time or resources to identify which companies have good governance practices, but many mutual funds do this for you. Most sustainable responsible impact (SRI) funds invest in companies with good environmental, social and governance (ESG) policies, and some funds engage directly with companies to help them improve their governance practices.

Here are a few examples of how funds have use governance to make a difference:

1. Greater diversity

Since 2012, Pax World Investments has filed gender diversity proposals at eight major companies. Five of those companies, including eBay, subsequently added new female directors. Studies suggest that companies with more women on their boards of directors had better performance.

2. Ethical business practices

Parnassus Investments decided not to invest in Valeant, a pharmaceutical company, because it questioned the company's business model. That turned out to be a smart decision: Valeant faced allegations that it defrauded insurers. Its stock price fell 86% in 2016, and the company's executives are facing criminal charges. Parnassus, on the other hand, was nominated for Morningstar's 2016 U.S. Domestic-Stock Fund Manager of the Year.

3. A 'say on pay'

Funds and organizations have been focused on executive pay for years because CEO pay in the U.S. has grown out of proportion to the economic or financial growth of companies. Since excessive CEO pay comes right out of a company's bottom line, it has been connected to future company performance. Efforts for reasonable pay got a boost when the SEC began requiring firms to disclose compensation packages in 2007. But there's still work to do, and fund companies like Domini, Walden and Trillium continue to engage with companies like AT&T, Target, Citigroup, JPMorgan Chase and Pfizer to give their boards or their shareholders a say on pay.

Domini has also worked with companies to reform the minimum wage. Domini met with Best Buy to create a more sustainable workforce through minimum wage reform and improved career options for employees.

4. Stronger privacy and data security

Good governance also includes keeping customer data secure. Trillium Asset Management has worked with Internet service providers, like CenturyLink, on their privacy practices, and it engaged with Verizon regarding Verizon's plans to buy Yahoo, a company that has had some serious data breaches.

Most sustainable funds focus on all three branches of ESG—environmental, social and governance. In the sustainable responsible impact portfolios that I manage, I aim to invest in diversified funds that have good ESG ratings and also have strong recent returns, and one fund that currently fits the bill is **Parnassus Endeavor** (PARWX). It's a fund that invests in companies that are great places to work, and this focus has paid off.

PARWX is up 40% for the year ending February 15, 2017, and you can buy this fund at most brokers without having to pay a transaction fee.

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Janet is president and CEO of FundX Investment Group, a San-Francisco-based registered investment advisor (RIA) that has helped... **Read More**