Avoiding the economic sins of “sin stocks”

DISCUSSION PAPER

REYNDERS, MCVEIGH CAPITAL MANAGEMENT, LLC

Every investment makes an impact. From investing in a farmer’s new machinery to buying shares in a tobacco company, the way your money is allocated influences humans, the environment, and the economy. At Reynders, McVeigh, we aim to allocate our clients’ capital to areas of financial growth that will leave a positive environmental, social, and governance (ESG) footprint. This is a multipronged investment discipline of supporting positively contributing corporations while also minimizing the impacts of “sin stocks” that we review here to affirm that they do not provide any existing financial or other net positive benefit to humans, the environment, or the economy.

THE ROLE OF “SIN STOCKS”

Sin stocks are companies that are in sectors with a clear negative influence on the world. In 2022, a convergence of events driven by the Russian invasion of Ukraine resulted in a sin stock rally. The war boosted firearms and energy companies that benefitted from skyrocketing oil prices, the Russian economy, and scarcity created by sanctions.

As fiduciaries with a socially responsible lens incorporated into our financial analysis of companies, we applied a deeper scrutiny of these industries to understand the long-term benefits and consequences of geopolitical events. Our analysis affirmed that companies operating in industries where the products and services directly harm human lives leave problematic footprints socially and financially.

Some investors argue that a portfolio must include all sectors to maximize returns, including those that have a negative environmental and social impact, citing modern portfolio theory. But this is simply not the case, as illustrated by Jeremy Grantham’s perspective on fossil fuel divestment.[1]

Grantham points out that divesting from the oil and gas industry, or any other, does not on its own threaten the health of a portfolio. The market has shown that over a century, removing one sector has little to no effect on returns when tracked against a relevant index. On the other hand, seeking out sectors that are positioned for a greater future impact (rather than trends of the past) can chart a more promising course.

“Investors with long-term horizons,” he concludes, “should avoid oil and chemical stocks on investment grounds. They face a sustained headwind.”

"SCREENING OUT" AS A BUILDING BLOCK TO IDENTIFY STRONGER COMPANIES

Socially Responsible Investing (SRI) was formed on the premise of negative screening: purposefully excluding sin stocks such as tobacco, privately owned prisons, firearms, and fossil fuels from a portfolio from a values standpoint. It has since evolved, and there are many different styles and strategies of what are variously coined as SRI, Sustainable Investing, and Environmental, Social, Governance (ESG) investing. In some of the strategies for this type of investing, the original premise gets lost, such as "best in class" ESG investing where investors include all sectors with the goal of mimicking an index.

At RMCM, we have a layered approach, starting with the fundamentals of negative industry screening not only from a *values* standpoint, but from a *value* standpoint. We then drill down further with our investment selection process though positive screening, seeking companies that are socially and environmentally thoughtful. We build on long-term themes that will continue to drive growth, such as automation, robotics, genomics, new health solutions, AI, efficient transportation, expanding power technologies, water infrastructure, and 21st-century manufacturing, to name a few.

By starting this investment process with an analysis of all potential present liabilities ("screening out"), we are able to eliminate weak fiscal and social companies to then "screen in" and allocate capital to areas of financial growth and a positive ESG footprint. We believe this allows us to uphold the highest fiduciary standard. We illustrate screening out in more detail below.

PRIVATELY OWNED, PUBLICLY TRADED PRISONS

Privately owned prisons are contracted to third parties by a government agency. The business model is simple: the prison is paid a monthly rate by the government per prisoner confined in the facility.

The history of private prisons in the United States dates to the American Revolution, which borrowed the concept from the United Kingdom. England put prisoners on ships that were left moored in English ports as a cost-effective way to remove them from society. In the 1980s, the U.S. private prison industry expanded to include publicly held companies such as Corrections Corporation of America (CXW) and the Geo Group (GEO).

GOVERNANCE

As an investment, these companies lack transparency. For safety reasons, prisons are exempt from federal disclosure laws and are not subject to the full Freedom of Information Act (FOIA). FOIA provides a formal process for requesting information from prisons.

It is with good reason that the layout of a prison or the personal information of prison workers is not made public. However, the FOIA exemptions reach beyond basic security information and inhibit oversight.

For example, quantitative data, such as reports of inmate abuse or the number of hours worked by inmates without a break, do not compromise the operations of the facilities or threaten security. Rather, this information provides insight into basic human needs, which are a civil right not to be compromised because an individual is in prison.

PERFORMANCE AND TRENDS

CXW has underperformed the Standard and Poor's 500 market index during the last decade through September of 2022. Both CXW and GEO changed their registrations from Real Estate Investment Trusts back to corporations in 2021. This coincided with GEO eliminating its dividend in 2021, showing management's concern with declining revenue.[2,3]

Prisons are also not immune to market downturns. According to the U.S. Department of Justice, total arrests as a proportion of the population decreased for consecutive years during the past three U.S. recessions. This includes from 1989–1993 during the 1990 oil price shock, from

1995–2003 during the dot-com bubble, and again from 2007–2011 during the Great Recession. As investors, we seek downside protection, but the downturns put these prisons in a category of investments without that protection.[4]

SOCIAL IMPACT

According to the Department of Justice, the percentage of federal prisoners in U.S. private prisons has been on a steady decline, decreasing from 19% in 2015 to 8.1% in 2019.[5,6] Further, movements like "ban the box," which require employers to remove questions related to a job applicant's criminal history, reduces recidivism rates, and leads to less employer discrimination and greater economic mobility.

But the incarceration rate in the U.S. is still among the highest in the world. Additionally, the government often guarantees 90% occupancy rates in prisons[7] such as those owned by CXW and GEO Group. This promise for a high level of occupancy encourages longer sentences, higher recidivism rates, and leaves a negative social footprint.

In January 2021, President Biden signed an executive order[8] as an initial step to incarceration system reform. The order has since directed the Justice Department to decline to renew contracts with privately operated, for-profit prisons.

On top of not being a fiscally prudent investment, privately owned prisons have a negative social impact, which leads us to conclude they are not fit for our portfolios.

TOBACCO

Cigarette smoking is the leading cause of preventable deaths of adults in the U.S., according to the Centers for Disease Control and Prevention. It is directly linked to one in every five deaths each year and causes more than 16 million Americans to suffer from smoking-related diseases.[9]

ECONOMIC IMPACT

It costs the U.S. more than $240 billion in healthcare spending from smoking and secondhand smoke-related health issues and deaths.[9] This is emotionally damaging for affected families and puts a tremendous financial strain on our healthcare system.

In 2019, the largest tobacco companies spent $8.2 billion marketing cigarettes and smokeless tobacco in the U.S.,[10] which is the equivalent of $22.5 million each day or just under $1 million every hour. There is a shift from cigarettes to smokeless tobacco products, which are also proving harmful.

Tobacco also affects employers and businesses, costing nearly $367 billion from lost productivity. It increases absenteeism, the use of disability leave, and overall healthcare costs among workers; the average annual cost to employers for an employee who smokes is almost $4,000 per smoker.[11]

As of 2017, the Affordable Care Act (ACA) allows insurance companies to add a premium surcharge of up to 50% based on smoking status.[11] Smokers can also see increases in homeowner's or renter's insurance and automobile insurance.

SOCIAL IMPACT

The industry's labor practices are highly questionable. U.S. federal law allows children to begin working between the ages of 14 and 15. In some states, children as young as 12 are legally able to work in agricultural positions for unlimited hours outside of school if they have parental permission.

It is contradictory that it is illegal for children to purchase cigarettes under the age of 18, yet it is legal for them to work in the fields where the substance is grown. Human Rights Watch research indicates that symptoms of nicotine poisoning appear in up to 73% of tobacco farm child laborers.[13] In addition to poor working conditions, these youths are paid an hourly wage of $7.25, which is the federally mandated minimum wage for states and far below a living wage.

PERFORMANCE AND TRENDS

Cigarettes are heavily taxed. There is a federal excise tax placed on each carton, which increased drastically from $0.39 to $1.01 in 2009. At the state level, the average excise tax is around $2.00, with the District of Columbia being the highest at $5.01 and Missouri the lowest at $0.17.[14] This creates a disincentive for consumers to smoke and to spend discretionary money on these products, but the addictive qualities of tobacco counteract this, ultimately compounding unhealthy habits with fiscal irresponsibility.

Americans are beginning to smoke less. From 2005 to 2020, the proportion of smokers decreased from 20.9% to 12.5%.[10] This trend seems to be continuing as awareness of the harms of smoking both on the smoker and those exposed to secondhand smoke becomes more widespread. The data provides a negative outlook for tobacco companies' profits going forward.

With the combination of increasing taxes and fewer smokers, tobacco companies are not sustainable investments.

FIREARMS

Firearms were one of the original sin stocks, and they are still heavily debated and politicized. There are practical use cases for guns; however, as socially responsible investors, we would be remiss to ignore the correlated trend line of increased gun purchases and gun-related violence in the U.S. and the significant negative impact on broader economic activity.

ECONOMIC IMPACT

As noted in a 2022 shareholder proposal (proposal 8) issued by the Employees Retirement System of Rhode Island, "gun violence has a negative financial effect both in the short and long term, as it suppresses productivity, destabilizes communities, and reduces business confidence."[15]

Short-term, there is an immediate cost, starting at the scene of the crime, including medical treatment and police investigations. Long-term costs like physical and mental health treatment, loss of earnings, and pain and suffering further compound the impact.

When looking at the economic fallout from gun violence, it is estimated that it costs the U.S. $557 billion annually, which is comparable to 2.6% of the U.S. GDP.[16]

Broken down, this is $2.8 billion in medical costs, $53.8 billion in work-loss costs, $11 billion in police and criminal justice costs, $0.5 billion in employer costs (lost revenue and productivity), and $489.1 billion in quality of life costs. This is five times the budget of the U.S. Department of Education.[16]

SOCIAL IMPACT

The number of homicides is increasing in the U.S. and is already higher than in many other developed countries. According to the Centers for Disease Control and Prevention, 70% of homicides involve firearms.

19,384 gun murders took place in 2020, the most since 1968. They represent a 34% increase from the year before, a 49% increase over five years, and a 75% increase over 10 years.[17]

These surges are almost a self-feeding cycle, with positive movement in firearm stocks often correlated to breaking news of another shooting. The horrifying reality of increased massacres in the U.S. inspires consumers to rush to purchase guns amid a perceived possibility of more stringent regulations being enacted.

Firearm purchases rose to record levels in 2020 and 2021, with more than 43 million guns estimated to have been purchased during that period, according to a Washington Post analysis of federal data on gun background checks.[18]

These numbers cannot begin to quantify the devastating impact on communities and families, many of which have a connection to gun violence. As suppliers to the consumers that become these statistics, firearms companies selling products do not pass social or governance screens.

PERFORMANCE AND TRENDS

Smith & Wesson Brands (SWBI) and Sturm, Ruger, and Co. (RGR) are two companies that manufacture firearms. Where RGR has performed in line with the market in 2022, SWBI has underperformed, and both companies have far underperformed the market over the long term.

As previously noted, we acknowledge that there are proper use cases of guns, such as defending human rights or hunting for food in rural areas. However, there is a massive governance issue around proper gun use and gun control in the U.S. Since gun control is such a heavily politicized issue and the government can be a slow-moving entity to act, with many interested parties at stake, we are seeing shareholders speak up for stricter gun control.

Along with the devastating human cost, this is not an industry that leads to long-term economic productivity and is in fact draining the U.S. economy and taxpayers.

FOSSIL FUELS

We have for years believed that "peak oil" is near, signaling a significant risk for the fossil fuel industry and companies that are overly reliant on oil and gas. While the sector may benefit from short bursts of high performance due to spikes in oil pricing, the reality is that fossil fuels are poised for decline and remain a significant contributor to climate change.

There is a greater long-term opportunity to be found in the transition to renewable energy sources, and our research shows an imperative to reduce overall dependence on oil and gas.

ENVIRONMENTAL IMPACT

Three fossil fuel sources—petroleum, natural gas, and coal—have made up at least 80% of total U.S. energy consumption for more than 100 years. That large output of nonrenewable energy carries outsized risk.

According to the United Nations, fossil fuels account for over 75% of global greenhouse gas emissions and nearly 90% of all carbon dioxide emissions, making the sector the largest contributor to the climate crisis.[19] As concerns about climate change and CO_2 emissions have become more prevalent and urgent in global discussions, the fossil fuel industry has been a primary target for activist investors.

PERFORMANCE AND TRENDS

Renewable energy shows the potential to meet demand with a much smaller environmental footprint. In 2019, renewables surpassed coal in the amount of energy provided to the U.S. and continued this trend into 2021.

Both public and private sector leaders are under intensifying pressure to meet the demands of the climate crisis by delivering on promises made as part of the landmark 2015 Paris Agreement: reduce emissions by 43% by 2030 and reach net zero targets by 2050.[20]

The onset of the war in Ukraine in February 2022 added even more urgency to the equation. The conflict significantly disrupted the global energy supply by blocking access to Russian crude oil; such a shock to the energy system is accelerating the transition to alternative forms of energy.

According to the International Energy Agency, this confluence of events brought peak oil closer to reality. "If governments make good on policy goals they have set in motion recently in response to the crisis," said the IEA, "they would speed up the shift from fossil fuels to cleaner renewable energy," resulting in peak oil demand by 2025.[21]

We are not naive to our reliance on fossil fuels; however, we never allocate capital to a sector with declining demand.

2022 was a challenging year for public equities. Energy stocks were consistently the only positive sector, finishing 59% in the green. We saw the price of oil surpass $100 a barrel for the first time in almost a decade before coming back down to more normalized levels of $70–$80/barrel.

As fiduciaries and long-term investors, the question then becomes: Is this a long-term trend, or short-term trade? This is where the concept of "stranded assets" comes into play. We question if the assets will earn their original economic promise due to changes in the landscape in which they operate, eventually devaluing to the point of becoming liabilities. In other words, fossils fuels could eventually become obsolete due to regulatory, environmental, or market constraints, such as delivery on international climate commitments like the Paris Agreement.

With the probability of fossil fuel assets becoming stranded assets, the nonprofit group Finance Watch is advising banks to treat these assets as high risk on their balance sheets, assigning them a risk weight of 150%.[22] This weighting is in line with the Basel Committee of Banking Supervision framework of liquidity coverage ratio (LCR) requirement for high-risk assets which were set in 2009 in response to the financial crisis for banks engaging in unethical banking practices and providing unsafe loans.[23] LCR refers to the proportion of highly liquid assets held by financial institutions to ensure their ongoing ability to meet short-term obligations, specifically, enough to fund cash outflows for 30 days. It is essentially a stress test for banks, ensuring that they have suitable capital preservation for short-term shocks to the market. Even though banking supervisors have acknowledged the financial stability risks from climate change, there are currently no bank capital requirement rules reflecting this risk. According to Finance Watch, 60 of the largest global banks have an estimated $1.35 trillion of credit exposures to fossil fuel assets on their balance sheets. By increasing the risk weight to 150% for fossil fuel assets, capital requirements for fossil fuel exposures would require a material additional $157 billion to $210 billion minimum of capital. To further put this figure into context, this is equivalent to an average of three to five months of net income per bank on average.[22] In our view, this makes fossil fuels an extremely high-risk asset that is not worth any potential short-term profit. This is also why we do not invest in large international banks, as we do not have full transparency regarding the risks on their balance sheets.[23, 24, 25, 26]

Many major public fiduciaries agree, including the former head of the Bank of England, Mark Carney, stating that companies that ignore climate change will "go bankrupt without question,"[27] and that pensions could be hit with "worthless" fossil fuels.[28]

As the reasons above have outlined, we believe that investing in fossil fuels is a short-term trade rather than a long-term investment and is not sustainable on multiple levels.

INVESTING WITH SRI

As forward-thinking investors, we seek opportunities where financial returns and social impact are aligned, and neither is sacrificed for the other.

In our experience, investing in sustainable business models with positive environmental, social, and economic footprints produces the best outcomes. When we apply our positive screening research process, "sin stocks" are not just concerns from a values perspective; they do not meet the criteria of a healthy investment.

ABOUT THE AUTHORS

Maria Demetra Egan advises individuals, families, trusts, and charitable institutions by implementing investment strategies that help clients of Reynders, McVeigh align their assets with their individual needs and values. She is an Investment Committee member and director of the Firm's shareholder engagement work. She sits as Trustee for clients, upholding the highest professional and fiduciary standards. Maria is on the Impact Investing Investment Committee, where she provides research expertise in the burgeoning private impact investments space. She has been with Reynders, McVeigh since 2010.

Maria is an active community member who works to increase economic mobility through financial literacy. Maria holds a bachelor's degree in management and an MBA from Clark University. She holds a certificate in community development finance from the Carsey School of Public Policy at the University of New Hampshire and participated in Rutgers Business School's Corporate Social Responsibility Certificate Program. Maria is a registered Investment Adviser Representative with her FINRA Series 65 license. She lives with her husband Brian and daughters Penelope and Sophia in Brookline, where they are active urban dwellers.

Jacqui Smith advises and manages investment portfolios for individuals, families, trusts, and charitable institutions and is on the shareholder engagement team. Prior to joining Reynders, McVeigh in January of 2021, Jacqui held positions as vice president, private client advisor at Bank of America Private Bank; senior fellow at the Intentional Endowments Network; senior sales manager at Gulf Oil; and energy advisor at Tradition Energy.

Jacqui received a bachelor's degree cum laude in communications and psychology from the University of Massachusetts, Amherst, and holds an MBA in economics of financial markets from Bentley University. She also holds the Chartered SRI Counselor designation and Series 66 license. Jacqui is an adjunct professor at Bentley University teaching Introduction to ESG & Impact Investing, is a member and former co-chair of the Boston chapter of Women Investing in a Sustainable Economy (WISE), a circle leader for Invest for Better, and a member of the Boston Women's Leadership Council. She also volunteers for the PJT Memorial Foundation on the South Shore, where she resides with her family.

[1] lse.ac.uk/GranthamInstitute/news/the-mythical-peril-of-divesting-from-fossil-fuels
[2] businesswire.com/news/home/20211202005319/en
[3] ir.corecivic.com/investor-faqs
[4] statista.com/statistics/191261/number-of-arrests-for-all-offenses-in-the-us-since-1990
[5] bjs.ojp.gov/library/publications/prisoners-2014
[6] bjs.ojp.gov/content/pub/pdf/p19.pdf
[7] inthepublicinterest.org/lockup-quotas-and-low-crime-taxes
[8] whitehouse.gov/briefing-room/presidential-actions/2021/01/26/executive-order-reforming-our-incarceration-system-to-eliminate-the-use-of-privately-operated-criminal-detention-facilities
[9] cdc.gov/tobacco/data_statistics/fact_sheets/fast_facts/index.htm
[10] cdc.gov/tobacco/data_statistics/fact_sheets/adult_data/cig_smoking/index.htm
[11] portal.ct.gov/DPH/Health-Education-Management--Surveillance/Tobacco/Costs--Consequences
[12] cpb-us-w2.wpmucdn.com/sites.wustl.edu/dist/1/2391/files/2016/04/The-Effects-of-Smoking-on-Health-Insurance-Decisions-Under-the-Affordable-Care-Act_updated.pdf
[13] hrw.org/news/2014/05/14/us-child-workers-danger-tobacco-farms
[14] cdc.gov/statesystem/factsheets/excisetax/ExciseTax.html
[15] sec.gov/Archives/edgar/data/1141391/000114139122000099/mastercard2022proxystateme.htm
[16] everytownresearch.org/report/the-economic-cost-of-gun-violence
[17] pewresearch.org/fact-tank/2022/02/03/what-the-data-says-about-gun-deaths-in-the-u-s
[18] washingtonpost.com/nation/interactive/2022/gun-deaths-per-year-usa/
[19] un.org/en/climatechange/science/causes-effects-climate-change
[20] unfccc.int/process-and-meetings/the-paris-agreement/the-paris-agreement
[21] wsj.com/articles/peak-fossil-fuel-demand-is-possible-in-a-few-years-iea-says-11666843203
[22] finance-watch.org/wp-content/uploads/2022/10/Tackling-financial-risks-related-to-the-fossil-fuel-financing-of-US-banks.pdf
[23] navi.com/blog/liquidity-coverage-ratio
[24] bis.org/basel_framework
[25] federalreserve.gov/econres/notes/feds-notes/climate-change-and-financial-stability-20210319.html
[26] finance-watch.org/wp-content/uploads/2022/10/A-safer-transition-for-fossil-banking-Finance-Watch-report.pdf
[27] theguardian.com/business/2019/jul/31/capitalism-is-part-of-solution-to-climate-crisis-says-mark-carney
[28] uk.finance.yahoo.com/news/bank-of-england-mark-carney-greta-thunberg-fossil-fuels-worthless-084903717.html
igentax.com/cigarette-tax-state
cdc.gov/tobacco/data_statistics/fact_sheets/adult_data/cig_smoking/index.htm
bjs.ojp.gov/content/pub/pdf/fv9311.pdf
bloomberg.com/news/articles/2022-10-03/fossil-fuel-financing-poses-growing-risks-to-biggest-banks
insideclimatenews.org/news/17012020/climate-change-fossil-fuel-company-lawsuits-timeline-exxon-children-california-cities-attorney-general

121 High St., 4th Fl., Boston, MA 02110 **(p)** 617.226.9999 **(f)** 617.226.9998 reyndersmcveigh.com @ReyndersMcVeigh