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No Performance Penance Needed: Catholic Values and Passive Equity Investing

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Faith-based individuals and institutions have a long, important history of integrating their values into their financial decisions. However, we still occasionally hear from advisors and consultants that they can be hesitant to recommend a Catholic values–aligned portfolio for fear of sacrificing returns. Instead of thinking Catholic values investing is destined for underperformance, it might be time to evolve this perspective. There's a way for Catholic investors to have it all.

Custom separately managed accounts (SMAs) have grown increasingly well known in recent years for helping investors respond to growing interest in environmentally responsible, socially conscious, and—for faith-conscious investors—faith-aligned portfolios. In our long experience managing passive Catholic values portfolios, we've seen investors achieve market-like performance while aligning portfolios with Catholic teachings. This paper helps explain Catholic values investing, shows how screening can affect an index-tracking portfolio, and explains how we mitigate unaligned investments through optimization. We'll also share our observations on other market segments, tax management, and the role active ownership can play.

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Background

All Catholic values portfolios are informed by the teachings of the Catholic Church, but the results can be quite varied, depending on how each investor chooses to translate these principles. The United States Conference of Catholic Bishops (USCCB) Socially Responsible Investment Guidelines (the guidelines) are typically the starting point Catholic investors use to build their portfolios. The USCCB is the national organization of Catholic bishops and is a leading voice for the Catholic Church in the United States. The guidelines outline six policy areas that correspond to Catholic teachings: protecting human life, promoting human dignity, reducing arms production, pursuing economic justice, protecting the environment, and encouraging corporate responsibility.

In addition, the guidelines highlight recommended strategies for each policy area, the most applicable for public equity investors being divestment (i.e., do no harm) and active ownership (i.e., encourage corporate responsibility through dialogue with management and their proxy votes). As a starting point, Catholic investors should first seek to influence the behavior of companies through active ownership and resort to divesting only if there is little chance of active ownership succeeding.

For example, let's look at the topics of adult entertainment and human rights under the policy area of promoting human dignity. The guidelines state that Catholic investors should avoid investing in companies that produce adult entertainment, as shareholder engagement can't reasonably be expected to change their core business practices. For human rights issues, where active ownership can be effective in improving company behavior and policies, Catholic investors should support shareholder resolutions aimed at protecting and promoting human rights, such as asking for reports on the human rights impact of the company's products and services and asking for additional transparency on a company's human rights policy implementation.

Although Catholic teachings cover a broad set of considerations and prioritize active ownership, only the divestment areas are relevant from a relative-return perspective, as these drive the differences in portfolio holdings from the index. When determining divestment criteria, the guidelines are helpful in setting high-level Catholic investing principles; however, they stop short of approving specific companies or even detailing exact criteria that should be used to evaluate potential investments. That's why the first challenge Catholic investors face is to translate the guidelines into a rules-based set of exclusion criteria. Investors often hire a dedicated Catholic research partner to do this work. This set of rules helps define the investible universe for the manager. The next step is to make sure the investor has clearly articulated their financial objectives, such as achieving yield, growth, tracking or outperforming a benchmark, or other objectives. The portfolio manager can then customize a portfolio to meet both the investor's financial and religious goals. For this paper, we focus primarily on investors looking to achieve a passive US large-cap portfolio aligned with Catholic values.

How restrictive is a Catholic values screen?

Some investors mistakenly assume that the guidelines might be too restrictive to allow them to get adequate exposure to a broadly diversified index. To address this concern, we present the impact of a typical screen and explain two ways to weight the portfolio after the screens are applied. For example, we use the S&P 500® Index, which includes approximately 500 large-cap stocks, and the Faith and Family Values (FFV) screen created by IWP Capital, a dedicated Catholic values research company.

At the time of this writing, IWP's FFV screen flags 43 companies, or about 10% of the S&P 500® Index by weight, for objectionable activities. As shown in figure 1, the companies with exposure to activities typically recommended for divestment are primarily concentrated in the health care sector because of business involvement in abortifacients, acute care facilities that provide abortions, contraceptive production, and embryonic stem cell usage. In particular, this limits access to biotechnology and pharmaceutical companies, which make up more than half of the health care sector by market cap. Companies that would require divestment include Johnson & Johnson and Abbvie.

While the concentration of companies typically divested from is most pronounced within the health care sector, there's some exposure within other sectors. The range of objectionable activities includes tobacco or cannabis production and the use of fetal stem cell research for goods in the consumer staples sector, weapons production in industrials, gambling in consumer discretionaries, and predatory lending in financials.

Figure 1: Exposure to activities recommended for divestment (hypothetical)

Sector	Companies that fail the screen	Companies that fail the screen (weight)	Index weight
Consumer discretionary	9	0.3%	11.7%
Communication services	–	–	11.2%
Consumer staples	5	1.8%	5.9%
Energy	–	–	2.3%
Financials	1	0.1%	11.2%
Health care	19	6.5%	13.7%
Industrials	9	1.6%	8.3%
Information technology	–	–	27.8%
Materials	–	–	2.6%
Real estate	–	–	2.7%
Utilities	–	–	2.6%
Total	**43**	**10.3%**	**100%**

Sources: Parametric, S&P 500®, IWP Capital, 8/20/2021. For illustrative purposes only. Not a recommendation to buy or sell any security.

Weighting method 1: The simple pro rata way

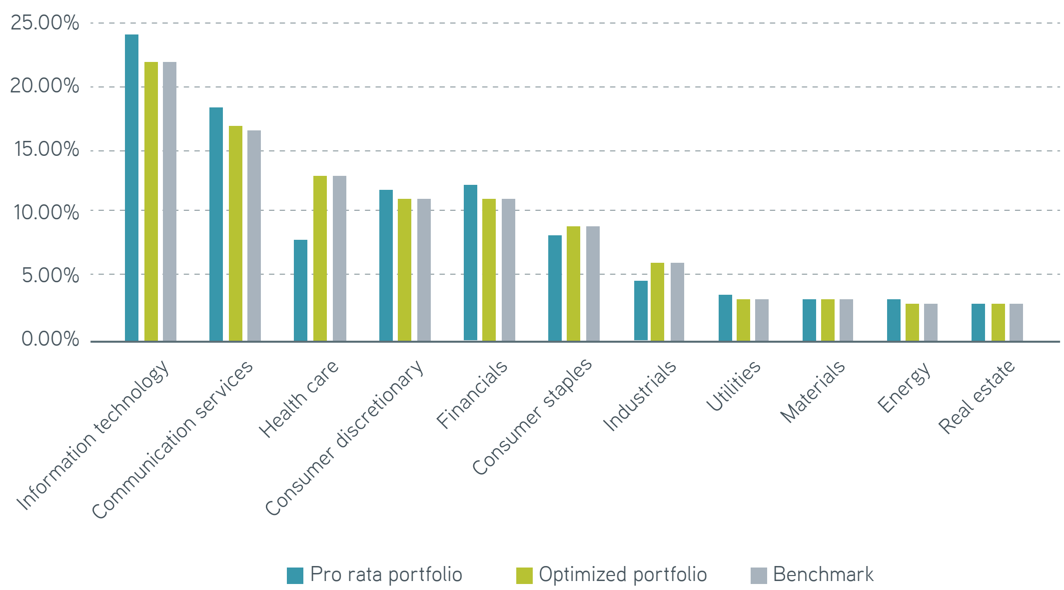
Once an investor has identified which companies pass their screen, the next question is how to weight them in the portfolio. A popular approach is to simply reweight them based on market capitalization. However, if the screen removes large-index holdings or a large number of holdings within a sector, this can leave the portfolio with materially different exposure to certain kinds of companies in the index and make it more difficult to produce index-like returns. In particular, this approach leaves a Catholic values portfolio particularly underweight to the health care sector. It also naturally allocates greater weight to the largest constituents and largest sectors. In this case, the approach overweights the information technology, communication services, and financials sectors. It also increases the portfolio's fundamental factor exposure relative to the S&P 500® Index to beta and growth and reduces exposure to yield. At the time of this writing, the predicted tracking error (PTE) for a portfolio using this screen and this weighting method is 1.2%.

Weighting method 2: A better optimized way

However, all is not lost for the Catholic values investor. Optimization techniques, coupled with a sufficient supply of replacement securities, can help investors create a portfolio with sector and fundamental factor exposure more similar to the index and reduce its PTE. Optimization is a mathematical technique that minimizes the expected performance deviation between a portfolio and a benchmark subject to constraints, including constraints to screen out securities from a benchmark. This allows the investor to better track the benchmark exposure by modestly deviating at the security level to better align sector exposures. In the screen we used for our analysis, there were enough companies still left within the health care sector that could be overweighted without relying too heavily on any given company. This was more easily accomplished in the biotechnology industry than the pharmaceutical industry, but overall, we were able to eliminate most of the health care underweight, reduce the overweights in other sectors, and reasonably align the portfolio exposure to the benchmark. At the time of this writing, we calculated bottom line PTE of 0.60%, halving the implied PTE from the pro rata reweighting scheme previously described.

Note that PTE provides point-in-time forward guidance on an annual basis and defines a distribution of possible outcomes. We may therefore see outsized performance deviations in either direction over shorter periods of time. In particular, this can be common for screened portfolios highly sampled in certain market segments.

Figure 2: Sector weights (hypothetical)



Sources: Parametric, MSCI Barra, July 2021. The portfolios presented are hypothetical and for illustrative purposes only. They do not reflect the experience of any investor and should not be relied upon for investment decisions. Actual portfolio holdings, returns, and characteristics will vary for each client. It is not possible to invest directly in an index.

Historical performance

Now that we have a sense of how a Catholic values portfolio might behave in the future, let's take a look at how it might have performed historically. For this perspective, we analyzed a Parametric composite of non-tax-managed accounts that have been managed in a similar fashion to the optimized weighting approach described above, using a similar exposure and screen.

Realized tracking error for this composite over the five years ending June 2021 was approximately 0.70%, slightly higher than the PTE estimate of 0.60% above. This occurs not only because predicted and realized tracking error always have the potential to differ but also because PTE itself changes over time as a result of changes in the risk characteristics of the underlying constituents, as well as changes in which companies fail the screen. In our sample, return deviations were larger early in the performance window in 2016 and 2017 and more moderate from 2018 to 2020.

It's important to note that although deviations can be offsetting over the longer term, investors can experience sizable deviations on a monthly basis, ranging anywhere from -70 bps to +70 bps during our sample period. Although rare indeed—there were only two such observations, one in each direction—investors should be aware that they can and do occasionally occur. On a rolling 12-month basis, we again observe some larger performance deviations of 1% or more, ranging from -1.3% to +1.6%. Despite that variation, since inception of the composite (5/1/2016), annualized gross returns have been within 0.10% of the benchmark.

Figure 3: Realized tracking error, 2016–2020

	2016*	2017	2018	2019	2020	ITD
Parametric composite	8.8%	22.9%	-3.8%	32.0%	18.2%	17.6%
S&P 500®	10.0%	21.8%	-4.4%	31.5%	18.4%	17.5%
Difference	-1.2%	1.1%	0.6%	0.5%	-0.2%	0.1%

Source: Parametric, 2021. For illustrative purposes only. The non-tax-managed FFV Catholic Values Domestic Composite is composed of all fully discretionary accounts that seek long-term capital appreciation by investing primarily in common stocks of US companies in the S&P 500® Index. Portfolios are screened to provide exposure to companies in accordance with the United States Conference of Catholic Bishops Socially Responsible Investment Guidelines. Past performance is not indicative of future results. It is not possible to invest directly in an index.

*5/1/2016–12/31/2016

In the longer term, investors shouldn't fret too much about achieving their Catholic values passive investment goals; it's a tractable problem, and we can and do construct well-tracking portfolios.

Impact on other indexes

Investors might sensibly ask if this analysis is consistent across other indexes; the answer is yes. MSCI EAFE has similar exposure gaps after Catholic values restrictions are considered. Importantly, because not every EAFE constituent has an investable American depository receipt (ADR), coverage gaps of ADR implementation of EAFE experience slightly higher tracking error than for a US-only universe. This ADR coverage gap adds 20 to 30 bps of additional PTE unrelated to restrictions on Catholic values. Mid-cap, small-cap, broad-cap, and even global implementation all have similar or better coverage than is implied by the S&P 500® investment discussed previously.

Tax management

Many individual investors are interested in tax management in addition to an implementation that considers Catholic values. The previously described optimization process and resulting 60 bps of PTE leave plenty of budget for tax management. It's true that adding restrictions on any portfolio is an additional constraint that tempers expectations for tax management. The aforementioned limitations in pharmaceuticals and biotechnology, for example, leave the portfolio with limited options for both exposure and tax management. But remember, we still have approximately 90% of the universe at our discretion, with flexibility to defer gains and accelerate losses. It isn't an overly constrained problem and doesn't force the investor to choose between Catholic values implementation or tax management; they can benefit from both.

From the perspective of performance, our composites have illustrated that the addition of a tax management objective has had no meaningful impact on pretax performance. Realized tracking error for our taxable composite is in line with our non-tax-managed composite performance, although as a standard, we allow up to an additional 1% PTE for most tax-managed mandates, so Catholic values investors might expect slightly higher tracking error for tax management. With respect to after-tax performance, the annualized tax alpha for the Parametric composite falls in line with expectations for unrestricted portfolios (between 1% and 2%) at 1.6%, indicating that the addition of the Catholic values restriction doesn't necessarily reduce the opportunity for tax management.

Role of active ownership

Catholic institutions and faith-based investors have a long history of active ownership. For decades Catholic institutional investors have advocated for Catholic issues through direct shareholder engagements with companies, as well as by filing shareholder resolutions. The first shareholder resolution with a social focus was filed by Catholic investors in 1971 to push General Motors to withdraw its business from South Africa until apartheid was abolished. Fast-forward to today, and Catholic and other faith-based investors are more vocal than ever, advocating and engaging on climate change, lobbying and political spending disclosures, drug pricing, human rights, and racial justice, to name a few. Looking at reports on US shareholder resolutions, you'd be hard-pressed to find a page that doesn't mention a saint, sister, or brother investor. Thanks to the good work done by Catholic institutions, all investors stand to benefit and can vote their proxies in alignment with their faith.

Investors can choose to vote their proxies themselves or delegate authority to their manager. At Parametric, our proxy voting policy is largely supportive of issues advocated by the Catholic community, including shareholder proposals on labor rights, human rights, and climate change action.

Conclusion

We've shown that adhering to Catholic values excludes far less of the S&P 500® Index than investors might imagine. Given the relatively minor impact of the screen when using optimization, Catholic investors are still able to own a market-like portfolio that is well aligned with their faith. Optimization techniques minimize sector, industry, and risk factor biases, creating a portfolio with reasonable tracking error to the target index. This is true in the US large-cap market as well as other market-cap segments and global markets. In addition, taxable investors are able to benefit from active tax management, because Catholic values investing doesn't overly constrain the investment problem and ample replacement securities remain in the universe. Coupling this approach with active ownership provides a holistic solution for investors interested in adhering to their Catholic values while achieving market-like performance.

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