MONTHLY

Market Review

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Voice Over Exit

Divestment or engagement?
Going beyond "feel good" to "do good"

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Depending on one's political leaning, the Trump presidency is either off to a chaotic start, or a fine-tuned machine in effecting changes and honoring campaign pledges. Investors have continued to give the President the benefit of the doubt, as the stock market rally got a second wind after he promised on February 9th that "phenomenal" tax cuts will be announced in a few weeks. The Dow Jones Industrial Average had a run of twelve consecutive closing highs, the longest winning streak in more than three decades. The threat of trade war also de-escalated for now as President Trump affirmed the "One China" policy and the Treasury Department has yet to name China a currency manipulator. The U.S. Dollar Index (DXY) recovered some of January's decline, although the rebound was mostly due to the euro sell-off over the French election uncertainty. The Fed started to sound more hawkish and nudged the market to recalibrate the odds of a March rate hike to 76% at month end, yet the U.S. 10-year Treasury yield has retreated to the lower half of its three-month trading range. The commodity complex was mixed with conflicting signals. Iron ore prices surged to three-year highs on solid Chinese demand and the reflation expectation in the U.S. Precious metal prices extended their strong rally in spite of the reflationary expectation. Crude oil prices traded in a narrow range, but U.S. natural gas prices collapsed due to the mild winter. The President capped off the month with an address to the joint session of Congress that was big on his "America First" vision. However, the devil is in the details with the Congress holding the power of the purse.

Equity Markets Indices[1]	1/31/2017 Price	2/28/2017 Price	MTD Change	YTD Change
MSCI All Country World	433	445	2.6%	5.4%
S&P 500	2279	2364	3.7%	5.6%
MSCI EAFE	1732	1753	1.2%	4.1%
Russell 2000®[2]	1362	1387	1.8%	2.2%
NASDAQ	5615	5825	3.8%	8.2%
TOPIX	1522	1535	0.9%	1.1%
KOSPI	2068	2092	1.2%	3.2%
Emerging Markets	909	936	3.0%	8.6%
Fixed Income				
2-Year US Treasury Note	1.21%	1.26%	6	7
10-Year US Treasury Note	2.45%	2.39%	-6	-5
BarCap US Agg Corp Sprd	1.21%	1.15%	-6	-8
BarCap US Corp HY Sprd	3.88%	3.63%	-25	-46
Currencies				
Australian (AUD/$)	1.32	1.31	0.9%	6.3%
Brazil Real (Real/$)	3.15	3.11	1.2%	4.7%
British Pound ($/GBP)	1.26	1.24	-1.6%	0.3%
Euro ($/Euro)	1.08	1.06	-2.1%	0.6%
Japanese Yen (Yen/$)	113	113	0.0%	3.7%
Korean Won (KRW/$)	1161	1130	2.7%	6.7%
US Dollar Index (DXY)	99.51	101.12	-1.6%	1.1%
Commodities				
Gold	1211	1248	3.1%	8.3%
Oil	52.8	54.0	2.3%	0.5%
Natural Gas, Henry Hub	3.00	2.52	-16.3%	-31.7%
Copper (cents/lb)	273	270	-0.9%	7.9%
CRB Index	192	191	-0.7%	-1.0%
Baltic Dry Index	800	859	7.4%	-10.6%

SOURCE: BLOOMBERG

From Audrey to Alexa

The world's first speech recognition system was developed at the Bell Laboratories in 1952. Named *Audrey* for Automatic Digit Recognizer, it was able to recognize digits 1 to 9 with a pause between successive sounds. It would have made an awkward telephone dialing assistant. IBM showcased its *Shoebox* speech recognizer at the 1962 World's Fair. It responded to sixteen spoken words, zero through nine and six arithmetic commands, making it a glorified calculator.

It's a choice between passive resistance and active stewardship.

Fast forward to 2011, iPhone's Siri brought the voice-controlled personal digital assistant to the masses. Siri not only supports more than 20 languages, but also has a personality. In late 2014, Amazon introduced the Echo device with a voice-controlled intelligent personal assistant named Alexa. Echo became a big success and was Amazon's best-selling holiday gift in 2016.

Now that is progress. Technology advancements create new markets, raise productivity, and also make some investors very wealthy. New companies unencumbered with legacy businesses can be especially agile and revolutionary. These innovative firms also tend to be the darlings of investors who value environmental, social and governance (ESG) factors. After all, it would take quite an effort for predominantly asset-light software companies to do big damage to the environment.

Pulp Friction

Surveys show that the most popular usages of Amazon's Alexa include searching and playing songs, asking for information such as the weather forecast, and re-ordering household items like toilet paper and diapers. While it is indeed convenient to verbally instruct Alexa to do these things, how much marginal utility or value is actually created? We may be so enamored with the wow factor of voice-initiated ordering of toilet paper that we forget the real heavy lifting is in the manufacturing of the toilet paper.

The life cycle of a roll of toilet paper starts out with the planting of trees that years later get harvested by loggers. Logs are delivered to sawmills to be debarked and chipped. The wood chips are mixed with chemicals to produce slurry that is then pressure cooked. The resulting pulp then goes through a multi-stage washer system to remove the chemicals and the hard lignin that binds the wood fibers. The washed pulp is then bleached, mixed with water, sprayed between moving mesh screens to create sheets of matted fiber. These sheets are pressed, dried, and creped to create the soft and textured feel. The paper is then loaded into machines that eventually wind it onto cardboard tubing and cut into rolls and wrapped up. Now that is the workings of a non-glamorous old industry.

A roll of toilet paper could also be quite controversial when it comes to environmental issues – deforestation, high water usage, wastewater discharge, and release of pollutants such as dioxins, sulfur dioxide and carbon dioxide. It's no wonder recycling is so important. However, recycled toilet paper may be contaminated with chemicals such as BPA and BPS, known endocrine disruptors that could cause health problems. Come to think of it, one should ask Alexa for a bidet or one of those fancy toilet seats common in Japan that squirt water. Alternatively, Alexa may want to suggest tube-free toilet paper and ask buyers to aggregate more items into a single shipment to be more eco-friendly.

Divestment or Engagement

The "grimier" side of some traditional industries has prompted some ESG-minded investors to stay clear of them. These investors have instead channeled money into securities of companies more compatible with their values. It has spawned a genre of investments with themes around social responsibility, sustainability, impact, low carbon, etc. Some have also joined the divestment movement with the goal of pressuring the targeted industries into more responsible behavior.

While the intention of the divestment movement is laudable, its impact is harder to measure. Divestment is a moral and political movement aimed at stigmatizing the targeted industries – tobacco, fossil fuels, to name a few

– and weakening their "social license" to operate. It is not hard to justify divesting tobacco-related investments since a business model built on enticing customers to become addicted to products that slowly kill them off is inherently immoral, and there is an alternative to smoking – quit smoking. However, it is not as easy a decision when it comes to excluding an *entire* industry that remains *essential* to the economy and has no viable substitutes.

Take the example of an industry that accounts for about 5% of the world's carbon dioxide emissions. Its energy use is voracious and its manufacturing emits greenhouse gases. At the end of its life cycle, the waste disposal also causes air pollution. These are the attributes of cement, the primary ingredient for concrete, which forms the foundation of the modern physical world from skyscrapers, bridges, to roads and dams. Many ESG investors would instinctively avoid the industry due to these environmental concerns. However, unless we are willing to live in mud huts or wooden cottages and travel on unpaved roads, the world is stuck with cement until cleaner alternatives can be produced economically.

One way socially responsible investors could make a real difference is to raise their collective voice to engage companies in these old economy industries to effect better practices. In the case of cement, investors could reward companies that actively seek to reduce CO2 emissions with more energy-efficient production, greater use of cleaner fuels, and R&D in material composition. Over time, the higher standards set by the more environmentally responsible cement producers would likely pressure the rest of the industry to adopt the "greener" practices. Indeed, some leading cement companies have been advocating a global price on carbon to pressure their "dirtier" brethren to reduce their greenhouse gas emissions. That's right, these companies want *more* environmental regulation, not less – apparently being greener can be a competitive edge.

In short, instead of shunning an industry with legacy issues, active shareholder engagement has the potential to set higher standards for the industry and lift everyone's game.

The Fierce Urgency of Now

Speaking of regulation, the Trump administration has made de-regulation a top priority. On Inauguration Day, the new administration put a freeze on all new and pending regulations in executive departments and agencies. President Trump then ordered that at least two existing regulations be repealed for every one new regulation issued.

This de-regulation zeal has proven to be emotionally divisive for the country. The business community and investors by and large appear to be quite excited – less regulation often means more growth. Progressives, on the other hand, are deeply worried that many of the last eight years' regulatory achievements will be rolled back. Environmentalists are especially alarmed by the confirmation of Scott Pruitt, the former Oklahoma Attorney General and a fierce critic of the Environmental Protection Agency, to head up the agency.

With the U.S. government actively seeking to roll back regulations on many fronts, now may be the time for socially responsible investors to emphasize engagement over divestment. Company executives and board members often respond to major shareholders, even if reluctantly. By taking on a more active shareholder role, likeminded investors can collectively raise their voice and engage companies in a constructive manner to encourage them to honor prior commitments in areas such as the environment, governance, disclosures, etc. Companies need to be reminded that business these days often operate on a global rather than regional scale and the political pendulum could also swing the other way in a few years. As such, firms that take the long-term view would be well advised to honor prior ESG commitments, and work on attaining global standards that will likely become more stringent over time.

To quote a line from a letter to investors by a well-respected investment manager: "I've taken the view that each of us can be bystanders, or we can be upstanders. I choose upstander." In the final analysis regarding divestment vs. engagement, it's a choice between passive resistance and active stewardship; the former makes one feel good, the latter lets one do good. ●

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