First Trust

FAITH BASED INVESTING NOTE:

Protestant Institutions

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Introduction

Socially responsible investment policies based on faith have come a long way since the early1400's B.C. when Moses prohibited the Israelites from demanding interest from fellow Israelites and poor Gentiles. (Lev. 25:35-37; Deut. 23:19-21). Early Islamic law prohibited earning interest as a 'haram' (or 'forbidden') practice as well and continues to do so today. Jesus explicitly stated one cannot serve both God and mammon. (Mt. 6:24). James, one of the earliest contributors to the New Testament, writing about AD 45, interpreted this in terms of fair business practices, rebuking the rich for fraudulently withholding wages of laborers. (Jms 5:4). In the late 1600s, the Quakers introduced social restrictions, leading the abolition movement in both the U.K. and the U.S. and forbidding Quakers from participating in the slave trade. In 1760, John Wesley, a prominent Methodist minister, gave his now-famous sermon, "The Use of Money", in which he reproved Methodists for exploiting others for personal gain and, in so doing, pioneered divestment from socially irresponsible companies.

Since the Civil Rights Movement in the 1960's, conservative Protestants have expanded their simple prohibitions against so-called sin stocks, alcohol, tobacco, gambling, and pornography, and now view as unacceptable a much broader spectrum of corporate practices, goods, and services. In 1977, for instance, Rev. Leon Sullivan, an African American Baptist pastor, authored the "Sullivan Principals", calling for divestment of corporations practicing apartheid in South Africa.

Investors of other faiths have increased their scrutiny of corporate products and services, as well. Islamic restrictions have expanded to exclude morally offensive music, videos, movies, and online dating. The United States Conference of Catholic Bishops (USCCB) issued their first socially responsible investment guidelines in 1991, followed by a second in 2003 and, in 2021, the current iteration. In 2022, the Vatican's Pontifical Academy of Social Sciences (PASS) released "Mensuram Bonam, Faith-Based Measures for Catholic Investors", presenting a modernized discussion of Catholic Social Teaching (CST) on investing.

To meet this growing demand, the late 20th century witnessed the burgeoning of a new approach to investing, known as Direct Indexing. Databases of stocks were built to identify companies around the globe whose products, services, or business practices violate one or more tenets of any of several faiths, including Protestant, Catholic, Islamic, and Jewish. For the first time in history, in lieu of holding agnostic indices, faith-based investors can readily identify and eliminate securities antagonistic to their faith from most equity indices globally, creating a customized portfolio fully aligned with their beliefs. This so-called negative screening approach gives investors the opportunity to have their cake and eat it too, removing galling exposures while maintaining acceptable tracking to their benchmarks.

Today, even after three millennia, investors of faith continue to wrestle with faith-based investing issues. After all, would James' rebuke be any less stinging if delivered to shareholders or management of a corporation fraudulently withholding laborers' wages today? Are shareholders exempt from blame when they knowingly invest in corporations with supply chains built on forced labor, human trafficking, or child labor? Should faith-based shareholders turn a blind eye to companies with known abuses in workplace discrimination, environmental destruction, or predatory business practices?

More specifically, what should Protestants do?

Should they remain invested in companies performing abortions, or gender modification surgeries on children, or promoting anti-family activism, or producing and distributing violent entertainment? What about companies supplying weapons and other materials to oppressive regimes? Should they tolerate and invest in companies charging usurious rates of interest to the poor?

If a company has multiple lines of revenues, what percentage of the company's revenue should Protestant investors allow to be tainted with unacceptable business practices before they shun ownership?

Faith Based Investing Note: Protestant Institutions

In this series of Notes, we will explore ways Protestant institutions and their investment committees may align their portfolios with their faith. The four steps to consider begin with *negative* screening, which is the focus of this paper. Three additional steps include *engaging* with company management on shareholder and management proposals, screening for *positive benefits,* and *missional investing*, or re-imagining the portfolio wholistically in alignment with the Gospel. Each of these four steps may be critically considered in building portfolios of faith.

In this Note, we explore recent efforts Protestant institutions have developed to express their faith—starting with negative screening. For many, negative screening is accepted as the 'baseline' or first step in creating faith-based alignment in their portfolios.

Negative Screening: What's the Issue?

Protestants have long viewed investing as part and parcel of their duty of stewardship. After all, everything we have is the Father's. We hold the assets entrusted to our care as stewards, custodians, or fiduciaries *for Him*. They are not ours to keep and, someday, will be left behind us. Nothing we currently manage can be taken with us. Thus, how we deal with what the Father has entrusted to us while we are here is central to our witness in the world. If we invest our portfolios as greedily, as thoughtlessly, and as self-centeredly as the world, how are we salt? How are we light?

An ever-growing array of concerns presents itself in the context of a global investment opportunity set. The need to address this individually has provided the genesis for *customized* faith-based investing. Customization tailors each investor's specific exclusions to only those he or she desires. This is far from 'one size fits all'. Each portfolio is a unique expression of the faith of the investor.

Protestants today consider a broad range of issues in formulating their investment policies. Not surprisingly, they do not agree on all points. Rather, common ground is found in some screens and disagreement on others. For instance, Conservative Protestants tend to be pro-life, while Progressive Protestants tend to be pro-choice. The point, however, is not necessarily to reach consensus, but to foster prayerful contemplation, frank discussions, and alignment of each institution's portfolio as they see fit.

To illustrate, common ground among both Conservative and Progressive Protestants is typically reached on issues involving pornography, human rights, slave labor, human trafficking, exploitation of the poor, religious discrimination, predatory lending, and violent entertainment.

Disagreement between Conservatives and Progressives persists in areas including abortion rights, contraceptives, fetal and embryonic stem cell research, gender modification drugs and surgeries, environment destruction, labor rights, private prisons, and weapons of mass destruction.

Four Types of Issues

Faith-based investing issues may be sorted into four general categories—Moral, Social, Environmental, and Governance. Of course, some of these issues are shared by some investors who are not faith-based.

Moral concerns include modern slavery, human trafficking, sweatshops, and child labor appearing in corporate supply chains. Questionable products or services may involve pornography, tobacco, gambling, alcohol, recreational cannabis, violent entertainment, gender modification drugs and surgeries, weapons of mass destruction, abortion, and embryonic and fetal stem cell research are also moral concerns.

Social concerns include workplace discrimination, labor rights, predatory lending, private prisons, rights of indigenous peoples, genetically modified food, capital punishment, animal experimentation, corrupt or unfair business practices, totalitarian regimes, and oppressive government practices.

Environmental issues revolve around issues affecting the common home, and include climate change, thermal coal and 'stale' assets, fossil fuel divestment, carbon risk, greenhouse gases, energy efficiency, air and water pollution, biodiversity and water stress, sustainable water, and sustainable forestry.

Governance issues speak to the way management conducts the affairs of the business, whether they are fair or unfair, trustworthy or corrupt, above-board or deceitful. Considerations may include corporate hiring and promotion practices, the ratio of minorities in a company's workforce, the number of women on their board, whether management allows workers to bargain collectively, and the disparity between workers' wages and managements' wages.

Importantly, Protestant values are not the same as the oft-mentioned Environmental, Social, and Governance metrics, or ESG. These metrics derive from different motivations and beliefs than the Biblically rooted values of Protestants. Although there are overlaps, Protestant beliefs often provide strikingly different views on many issues.

The following are negative screening issues Protestants institutions are considering.

Issues for Protestant Institutions

Moral	Social	Environmental
Abortion	Capital punishment	Carbon footprint
Alcohol, tobacco, and gambling	Discrimination	Environmental destruction
Cannabis	Diversity	Fossil fuel free energy
Child labor	High fructose / poor nutrition	Genetic engineering
Gender modification surgery	Human rights abuses	Greenhouse gases
Modern slavery and Human trafficking	Labor rights abuses	Nuclear energy
Stem cell research	Predatory banking	**Governance**
Sweatshops	Private prisons	Bribery & corruption
Violent entertainment	Sexual harassment	Diversity and inclusiveness
Weapons of mass destruction	Unsafe products	Supplying oppressive regimes

Portfolio Construction

To create a negatively screened portfolio, investors start by determining which corporate products, services, or practices are antagonistic to their faith. This may require soul-searching and contemplative discussions among the investment committee with input from leadership or external advisors. Once selected, these screens will be applied to the equity index or indices used by the institution to benchmark performance.

Major screening services offer large databases, containing thousands of global stocks, with pertinent information about each relating to their products, services, management, supply chains, involvement in areas of controversy, lawsuits by non-governmental organizations (NGOs) and more. These data enable thoughtful screening to occur with a level of significant detail.

By carefully selecting a set of screens pertaining to the issues they have chosen, an investment committee can engineer the custom outcome they seek. Exclusion decisions do not need to be ‘black or white’: committees may consider shades of gray by adopting materiality thresholds, or levels of revenues below which a company is not excluded.

Once the screens are chosen and materiality thresholds are selected, the institution may apply them to their benchmark(s). This will identify companies which are non-investable. The easiest way to build a portfolio is to *optimize* the “survivors”, or acceptable companies, by choosing a portfolio from among these survivors and weighting them *inter se* to create a portfolio whose performance should best track that of the original benchmark.

Once a screened portfolio is built, computer programs can calculate the degree of performance variation expected of the screened portfolio relative to the unscreened benchmark. This represents the screened portfolio’s “tracking error”. Think of this as the annual amount by which the screened portfolio may deviate from the benchmark. Importantly, tracking error is expressed as a standard deviation, meaning that the screened portfolio is expected to perform within a range of returns, plus or minus that of the benchmark.

Built properly, screening need not impair results—in fact, a screened and optimized portfolio is just as likely to improve results as to dampen them, and to the same degree. This is the underlying theory supporting tracking error. For instance, if a screened portfolio has an expected tracking error of 0.7% to the benchmark, the portfolio’s returns are expected to mirror the benchmark’s returns within a range of plus or minus 0.7% in any given year. If this occurs randomly, over time the return differentials are likely to wash out.

Institutional investors ordinarily establish a ‘tracking error budget’ or the degree of performance deviation from the institution’s benchmark they will accept from their screened portfolio. Setting this in advance will assist the institution in understanding and defining limits to the breadth and depth of their exclusions. Investors may wish to run several iterations of screens, solving for differing materiality thresholds and tracking errors each time, to identify the screens and materiality thresholds which meet their tracking error budget.

Typically, investors will seek the services of a professional direct indexing firm to assist in this process and manage the resulting portfolio(s). Securities are usually held at the investor’s own custodian in a separately managed account (SMA). Taxable institutions, such as large family portfolios and nuclear decommissioning trusts, may also wish to arrange for tax loss harvesting on their portfolio in an attempt to maximize their after-tax performance.

Conclusions

Protestants have long recognized their foremost duty is to love God, and their second duty is to love thy neighbor. Loving thy neighbor requires treating them as one would treat themself, not contemptibly or with callous disrespect, but as one would like to be treated. The management of portfolios can serve as a powerful witness for the world. Let's prayerfully consider how to best manage our assets as Godly fiduciaries, rightly dividing the Word of Truth, and displaying in practice our love for God and Man.

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The strategy was previously managed by First Trust Direct Indexing ("FTDI"). Effective October 31, 2024, FTDI merged into First Trust Advisors L.P. ("FTA"). All business activities, including portfolio management and business records are now performed under FTA.

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