STRIVE

The Fiduciary Focus

Investment News From a Pro-Shareholder Perspective

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This Week: Missouri asks court to uphold rule requiring investment advisors disclose ESG practices to clients; Strive analyzes the semiconductor market; an Eye on Energy discusses the the market impact of the war in Israel; and more.

Missouri Asks Court To Uphold ESG Transparency Rules

Last week, Missouri asked the court to toss a lawsuit over ESG transparency rules.

The lawsuit, brought in August, asks the court to strike down a Missouri law that requires investment advisors to obtain the informed consent of their clients before using their money to pursue any "non-financial objectives."

According to plaintiffs, the law is invalid because investment advisors have a constitutional right to conceal their true motives, including diverting client money to social and environmental objectives, from their clients when investing their funds. More specifically, they claim the law infringes on investment advisors' free speech rights under the First Amendment because they have a right to tell investors how their money is being used.

Missouri has asked the court to dismiss the case on several grounds, including, of course, on the merits. In its brief, Missouri explains that the State is permitted to pass laws to protect investors and that requiring investment advisors to provide truthful disclosures about how client money is being used does not present any First Amendment concerns.

While it is not yet clear how the court will rule, the case highlights an underappreciated concern in the ESG debate: Many ESG proponents not only seek to use investor money to pressure corporate America to adopt social and environmental objectives, but they also seek to do so without the knowledge or consent of the very investors whose money is at stake. The court's ruling is therefore likely to provide guidance on what steps lawmakers can take, if any, to protect investors from such fraud and force investment advisors to comply with their fiduciary duties to focus on financial value alone—or, at the very least, inform their clients when they are declining to do so.

China Offshores EV Manufacturing, Evading EU Probe On Subsidies

Chinese carmakers are diversifying their manufacturing of electric vehicles into Southeast Asia amid the EU's calls to investigate the CCP's use of state subsidies, the South China Morning Post reported Tuesday.

The effect of the move will likely allow Chinese manufacturers to dodge the probe, since EU regulators are unlikely to expand their investigation into operations that take place in EU-friendly jurisdictions like Thailand, the outlet explained.

Heavy subsidies for local businesses from the CCP have long drawn fire from both the EU and the United States, as they allow Chinese companies to sell at below-market rates, thereby undercutting prices offered by Western manufacturers.

EU regulators fear the EV market will soon be dominated by Chinese players and push EU-based EV makers out of the market, repeating a pattern seen in the solar panel and wind turbine industries. Like electric vehicles, the technology used in those industries was initially developed largely by Western companies, who were then forced to hand over their intellectual property to the CCP in order to gain entry to the Chinese consumer market. Soon, however, the CCP began subsidizing local competitors, who were then able to sell at lower price points both in China and globally, ultimately driving Western firms out of the market.

The U.S. has expressed similar concerns. In July, Treasury Secretary Janet Yellen met with Chinese officials and "pressed them on our serious concerns about China's unfair economic practices," including intellectual property theft and subsidies for local businesses that prevent "American firms [from] compet[ing] on a level playing field."

Tesla, for instance, has been impacted by the CCP's attempts to bolster homegrown companies at the expense of foreign firms. But so has Apple. Ultimately, the CCP's campaign has far-reaching effects, and put American companies that do business in China in a difficult position: Accept discriminatory treatment by Beijing, or speak out and risk its ire.

Alabama Pension Fund Pushes Back On Claim That It Supported ESG Proposals; Its Response Proves Otherwise

In last week's Fiduciary Focus, we mentioned a new report by the nonprofit 1792 Exchange showing red state pension funds lent huge support for pro-ESG shareholder proposals. This week, Alabama is pushing back. But its response may only have dug the State into a deeper hole.

According to Alabama-based 1819 News, the study showed Alabama supported pro-ESG proposals 49.5% of the time, placing it third in the nation after only Tennessee and Wisconsin. Following publication, a pension fund spokesperson reached out to the outlet, accusing reporters of relying on "faulty" information because Alabama uses State Street only as a custodial bank, not to vote its shares.

When pressed, however, the Alabama pension fund admitted that it does not vote its own shares, but that it instead allows the proxy advisory firm Glass Lewis to do so. The problem? Glass Lewis supports even more pro-ESG proposals than State Street, meaning the report actually understates just how pro-ESG Alabama's voting record has become. For example, the proxy advisory firm pledges to vote for racial disclosures and to hold companies accountable for climate-related issues; State Street also generally supports these causes, but its record is somewhat more mixed.

And while Alabama tried to dodge scrutiny by claiming that it voted "with management on 92% of the votes last year," this figure undoubtedly includes routine votes—like approving an auditor and how often to hold votes on executive pay—that make up the vast majority of corporate ballots and rarely draw controversy. When it comes to ESG issues, Alabama's support is likely much, much higher.

Glass Lewis's troubling voting practices should not come as a surprise to Alabama. Earlier this year, Alabama's Attorney General, joined by prosecutors in twenty other states, sent a letter to Glass Lewis alleging that its "climate and diversity, equity, and inclusion priorities" may "violate[] their legal and contractual duties" to the State.

While shareholder primacy advocates praised Alabama for being transparent about its use of Glass Lewis, the revelation underscores the need for state pension funds to be more open about how they vote their shares. Only 19 States currently disclose their voting records directly to the public. Most pensioners, in other words, remain mostly in the dark about how their pension fund money is being used.

The Coming Crackdown On "Greenhushing"

Greenhushing—the practice of deliberately understating or hiding a company's environmental efforts to evade scrutiny—has made headlines in recent months as businesses have toned down their climate-related rhetoric to avoid political controversy. But some ESG advocates, including EU regulators, are pushing back—particularly when it comes to requiring transparency in the asset management industry.

Patrik Karlsson, a senior policy officer at the European Securities and Markets Authority, recently warned fund managers that, going forward, they are as likely to be penalized for understating their ESG efforts as overstating them, Lexology reported last week. As Bloomberg put it, the EU regulator believes "'[g]reenhushing' . . . can be as bad as 'greenwashing,'" as it leaves clients in the dark about how their investment money is being used.

This warning echoes concerns that Strive raised with the United States Securities and Exchange Commission last year. At the time, the SEC was considering rules to crack down on "greenwashing"—i.e., the practice of advertising a fund as environmentally or socially conscious, when in fact it was focused exclusively on making money. Strive wrote to the Commission to share its concern about what it viewed (and continues to view) as a much larger problem—"greenhushing" or "greensmuggling"—in which fund managers like BlackRock, Vanguard and State Street advertise a fund as being focused only on financial return, but then use the money in those funds to promote environmental or social goals instead.

The need to crackdown on greenhushing may therefore be the rare development on which all sides of the ESG debate can agree. Investors deserve full transparency on the goals a fund manager plans to pursue using their investment dollars, and asset managers should not be able to avoid scrutiny by staying mum.

Straight From Strive

Sector Spotlight: Semicoductors

The semiconductor sector stands at a unique moment where it is lifted by the generational tailwind of AI but faces the generational headwind of Chinese action against Taiwan.

Semiconductors have long been a paradigmatic growth sector because the microchips they create are crucial to many industries, including health care, defense, computing, communication, and transportation. When the economy booms, so does semiconductor demand. But rapid progress in artificial intelligence is adding a powerful new growth driver that flips the usual market dynamics: now, demand for AI chips may make the economy boom.

The key is a new approach called generative AI, where neural networks are trained to recognize patterns in vast amounts of data and use those to create images and text. The technology now performs at the level of a skilled human at many cognitive tasks: GPT-4 scores around the 90th percentile on the uniform bar exam, the LSAT, the GRE, and a variety of other tests. 53% of businesses already use generative AI to increase productivity. According to Goldman Sachs economists, the technology could boost U.S. labor productivity by 1.5 percentage points per year for the next decade, doubling the historical rate since 2005.

Rather than betting on particular software companies, semiconductor companies are the pick-and-shovel play of the AI gold rush. Analysts estimate AI chip sales will have a compound annual growth rate between 30% and 46% from now to 2030.

But in spite of the analysts predicting a new Roaring 20s led by AI, the sector faces heightened geopolitical risk. The Taiwan Semiconductor Manufacturing Company (TSMC) accounts for more than 90% of global output for advanced semiconductors, yet national security experts increasingly agree China is likely to take military action against Taiwan by 2027. Not only would an invasion or blockade sever semiconductor supply chains, the competition between the U.S. and China raises the risk of regulatory action hindering semiconductor sales to China today. Of course, rising geopolitical risks presents opportunities for the sector as well, particularly in the U.S. where the Biden Administration has committed $52 billion to bolstering domestic manufacturing.

The geopolitical risks to the semiconductor sector are serious, but the potential reward of benefiting from historic advances in AI is at least equally compelling. Investors could benefit by finding ways to respect both the risk and the reward.

An Eye on Energy

The War in Israel Pressures the Market

The outbreak of war between Israel and Hamas has placed an upward trend on the price of oil (estimated $3 a barrel (b) 'war' premium on Brent). U.S. benchmark West Texas Intermediate (WTI) 'war' premium is being assessed but was trending at over $3/b at 2:00 p.m. on October 9.

October 9, WTI's open at $86.05 was driven by market sentiment in reaction to the invasion of Israel by Hamas on October 7. WTI climbed from $82.79/b on Friday.

This event may have reversed a downward trend from last week. The WTI and Brent fell to their lowest levels since August because of concerns about demand for oil products. WTI peaked with resistance at around $93.96 on September 27.

The current perception of a tight supply of oil, coupled with the uncertainty over the direction of the war, will likely cause volatility in the price of oil. We will continue to watch if the degree of the current $3/b Israel 'war' premium will ease as the situation becomes clearer and its behavior if the situation stabilizes.

At the moment, the probability of a high-impact scenario that the conflict will spread is being assessed. If Iran becomes directly involved, or a potential proxy conflict emerges with Iran having a role, it will place upward pressure on the price of oil. Also, if a regional conflict increased the market 'sentiment' that a real risk against oil tankers in the Persian Gulf is possible, this could push the price of oil in the $130 range.

High oil prices typically drives economic and geopolitical risk. Additional near-term risks that we are watching include recession in Europe and the political landscape in the U.S., including the election of the Speaker of the House of Representatives this week and Congress's ability to avert a government shutdown by November 17.

If high energy prices push headline inflation up, central banks may have room to raise rates in November, adding to a perceived risk of deepening an economic downturn.

The Best of the Rest

Additional stories about ESG investing, company happenings, and more.

- State Street upped support for key ESG proposals in 2023; supported 66% of key ESG proposals in 2023, up from 59% in 2022, Morningstar reports.
- Asset managers beginning to shift ESG stances; "if you're in the money management business, you do need returns," S&P's Daniel Yergin said.
- Exxon looks to buy driller Pioneer Natural Resources; $60 billion megadeal would give Exxon a key position in the Permian Basin of West Texas and New Mexico.
- U.S. chipmakers pushing back on President Biden's China agenda; concerned that new regulations may hamper their ability to sell into the Chinese market.
- Sustainable jet fuel will always cost more than kerosene, International Air Transport Association says; airlines are pushed to move to green fuels anyway.
- ESG bond issuance heading for slump; Goldman Sachs predict volume to be slashed in half compared to last year.
- Pro-fiduciary movement safe, despite McCarthy ousting; the two likely successors to the Speaker of the House role, Steve Scalise and Jim Jordan, have both fought to protect investors from politicized investing practices.

Strive News

Last Tuesday, Strive Senior Vice President and Head of Research Chris Nicholson spoke on a panel at Bucknell University on ESG investing.

During the discussion, panelists fielded questions on what ESG means, whether more uniform ratings are needed, and why ESG funds have enjoyed such popularity over the past ten years, even if that trend appears to be on the wane.

Strive's Nicholson explained that Strive does not do values-based investing, instead focusing solely on maximizing financial return. And on that issue, he emphasized that Strive likely has a different assessment of, for example, the likely economic impacts of climate change compared to other firms. He cited a number of studies indicating that global warming will likely lead to about "a 3% loss to global output," which he suggested would not justify sacrificing returns today by demanding Exxon drill or frack less.

He also spoke on the debate between stakeholder capitalism and shareholder primacy, explaining that it seems a little "backwards" to say a company should care equally about its suppliers and owners; suppliers should be serving the company, after all, not the other way around. Yet the European investment model seems to be hyper-focused on stakeholder capitalism, and using ESG as a means to implement it. Panelists also discussed artificial intelligence, BlackRock's false "retreat" from ESG, and more.

The full discussion is available for viewing on Vimeo.

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What Makes Strive Different?
While many asset managers push companies to focus on other stakeholders such as employees, suppliers, the environment and society at large, we live by a strict commitment to shareholder primacy — the belief that **the purpose of a for-profit corporation is to maximize long-run value for investors. Click here** to learn why shareholder primacy is so important.

How Does Strive Maximize Value?
Our corporate governance team engages with the companies in which our clients are invested to advocate for the pursuit of excellence in corporate America. We are aggressively apolitical when it comes to utilizing our corporate governance tools and demand that companies focus exclusively on delivering long-term financial value for investors. The corporate governance team also determines how to cast our shareholder votes at annual meetings and special elections, evaluating each proposal through the lens of maximizing financial return.

Our research team conducts deep analysis of macro economic trends, market developments, and industry- and company-specific metrics to identify potential risks and opportunities for our clients. We then incorporate the results of this research into our engagement and voting strategy, and share it with our clients in the form of white papers and market research reports so they can make the most educated investment decisions possible.