Part 1: ESG Funds – The Stormtroopers of the Investment World

Aptus ESG Topics:

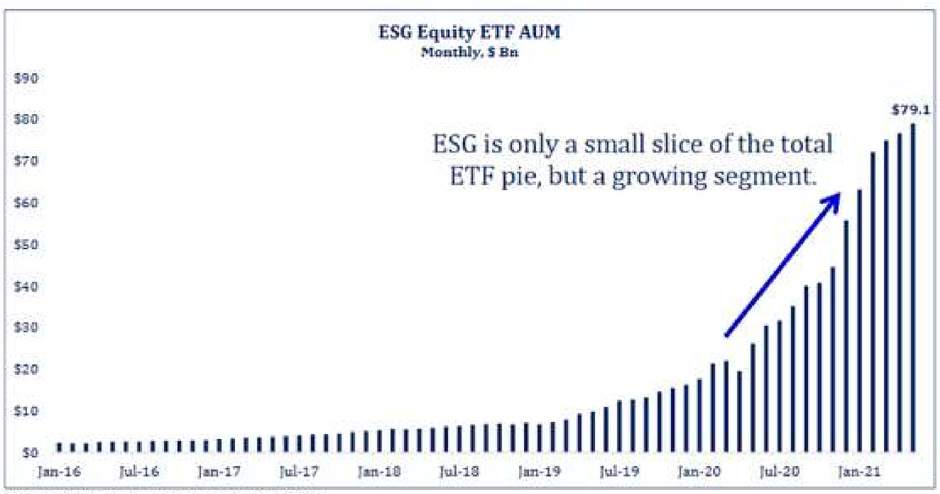
Part 1: ESG Funds Missing the Mark

Part 2: How Aptus Incorporates ESG into its Investment Process

Part 3: HNW Holdings ESG Breakdown

In Star Wars, there are few things more puzzling than the stormtrooper. More specifically, the contradiction between their reputation (Obi Wan states "only imperial stormtroopers are so precise") and what we see (wildly inaccurate shooting). We believe that ESG funds are the stormtroopers of the investment world. Investors believe these funds to be ruthlessly efficient in providing the kinds of socially responsible companies they want to own, when the reality, their aim is nearly as bad as those hapless stormtroopers.

Born within the confines of foundations and college endowments, the trend of owning ESG has spread to public pension plans and most recently, individual investors. This should come as no surprise given that we live in a time in which social media links politics and popular culture. Furthermore, asset managers have been increasingly asked to take into account the environmental and social impact of the companies they own while paying attention to the standards of governance, given that they are managing other people's money. To prove it, just look at the amount of assets that have flown into ESG-related funds over the last two years:



Source: Strategas, Data as of 5/21/2021

At Aptus, we believe that understanding ESG is pivotal to our overall investment process – we want to do well, by doing good. We will get more into our methodology on the second part of this series, but for this part, we wanted to show you where we believe most people are missing the mark on ESG investing. To show this, we will walk through the following three issues:

- Same Exposure as the S&P 500
- Inconsistency Surrounding Holdings
- Pricing

Same Exposure as the S&P 500:

The most popular ESG ETF, the iShares ESG Aware ETF ("ESGU"), has ~22% of all assets in this thematic space – the dominant player. So, let us pick on this fund. If you look below, do you see any difference between the sector allocation or top holdings?

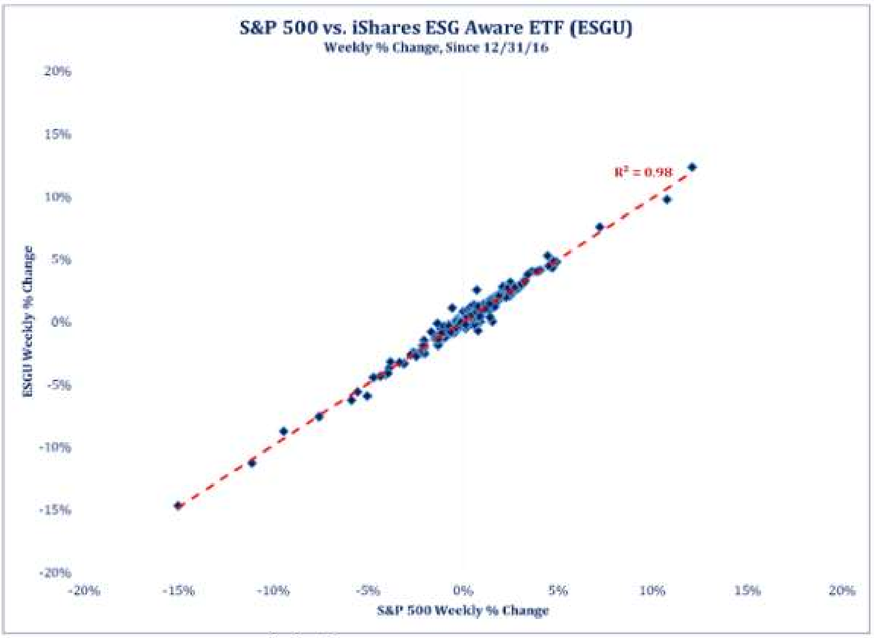
Sector Exposure			
Sector	ESGU Weight	S&P 500 Weight	Difference
Technology	27.0%	26.0%	1.0%
Industrials	9.9%	9.0%	0.9%
Real Estate	2.9%	2.5%	0.4%
Health Care	13.1%	13.0%	0.1%
C. Staples	6.1%	6.1%	0.0%
Energy	2.8%	2.9%	-0.1%
Materials	2.7%	2.9%	-0.2%
Utilities	2.3%	2.6%	-0.3%
Financials	11.5%	12.0%	-0.5%
C. Discretionary	11.4%	12.1%	-0.7%
Comm. Services	10.1%	11.0%	-0.9%

Source: Bloomberg, Aptus Capital Advisors, Data as of 5/26/2021

Top 10 Holdings			
Company	ESGU Weight*	S&P 500 Weight	Difference
Apple	5.68%	5.65%	0.03%
Microsoft	5.08%	5.36%	-0.28%
Amazon	3.68%	3.93%	-0.25%
Alphabet	3.78%	3.78%	0.00%
Facebook	1.96%	2.22%	-0.26%
JPMorgan	1.34%	1.39%	-0.05%
Tesla	1.23%	1.31%	-0.08%
Nvidia	1.15%	1.09%	0.06%
Johnson & Johnson	1.13%	1.26%	-0.13%
Home Depot	1.10%	0.96%	0.14%
SUM	**26.13%**	**26.95%**	**-0.82%**

Source: Bloomberg, Aptus Capital Advisors, Data as of 5/26/2021, * Sorted

If you start to get into the weeds of this funds, you find out that it's very difficult to find any material differences. More importantly, the fund itself has a **98% correlation with the S&P 500 – basically identical to the broader index**.



Source: Strategas, Data as of 5/21/2021

Inconsistency Surrounding Holdings:

We believe that viewing all companies and the products they produce through a lens of virtue leads to very few easy decisions regarding investing. For example, per MIT Sloan's working paper entitled "Aggregate Confusion: The Divergence of ESG Ratings", the correlation between ESG ratings across different providers is around 0.3. This contrasts with credit ratings, where the correlation between ratings by S&P and Moody's is around 0.99. Let's delve into some examples here:

Now I'm no expert here, but the inconsistencies are unexplainable in my mind on two different levels.

1. Binary Discrepancies - ESGU owns General Motors (GM) and Tesla (TSLA), but does not own Ford (F). That does not make sense to me. Furthermore, ESGU does not own Lockheed Martin (LMT), Boeing (BA), and Northrup Grumman (NOC) – which we feel is understandable, but owns Textron (TXT) and Honeywell (HON) is contradictory. We believe that there needs to be consistency.
2. Rating Discrepancies – Rating companies rate/rank the same companies differently. Examples:
    a. Provider 1 ranks Wells Fargo as top-quartile in Governance, while Provider 2 ranks it in the bottom 5%. That's because Provider 1 counts the fake bank accounts scandal within "Information to Customers", which is part of its Social score, not Governance score.
    b. Provider 1 gives Facebook a top 10% Environmental rating, while Provider 2 ranks it in the bottom 30%. That's because their environmental ratings measure quite different attributes, and each attribute has different weights.

Now, what does this tell investors? And we'll get into this more in *Part II*. We think it means that we cannot solely rely on ratings – there needs to be a deep understanding of a company - talk to management and take into account its strategic context – means that human investors can add what we believe is a substantial amount of value even in a big data world.

Pricing:

As we continue to pick on ESGU, and this is very consistent amongst all ESG funds, the biggest difference and the most appalling problem to us is pricing. Given that you are basically getting a S&P 500 exposure, why are investors carrying a freight of 15bps in expenses for ESGU – relative to an index fund around 3bps? In short, from our perspective, and what is often not said, is that the products being sold to achieve these social goals are little different from the broader Index itself, merely more expensive.

Conclusion:

First, we love that a lot of our clients understand the societal and alpha-generative benefits of ESG. At Aptus, we believe that there is a lot of validity in ESG – **we want to do well, by doing good**. But we want to make sure that we are hitting the intended target of the desired exposure.

For simplicity, since this topic is far from that, we'll heed to Yoda's basic advice: "you must unlearn what you have learned". And that's what is most exciting about Part II of our series - we'll continue to show you how we don't rely on some of what we consider the misleading thematic funds out there and how we incorporate ESG investing as a tool in our toolbox when fundamentally analyzing companies.

Don't be a stormtrooper, be a Jedi.

Part 2: How Aptus Incorporates ESG into its Investment Process

Aptus ESG Topics:

We cannot claim that we are Jedi's in this space, but, we won't claim to be a stormtrooper either – we are somewhere in the middle.

Dating its origins back to the 1980s - ESG has changed over the last few decades, as it used to be a novel concept. Though, it was much simpler in nature – it tended to be more black and white - is this specific investment socially-responsible? Sustainability value and corporate ethics were not at the forefront of investment conversations. Management teams were never asked about the diversity of their business and the number of women in management. Fast forward to today, these are table stakes.

The focus is now towards companies that steward the following characteristics:

1. Companies that treat the environment with respect,
2. Diversity and inclusion,
3. Sustainability Value,
4. Corporate Ethics, etc.

Every day we are thinking about climate change, social inclusion, diversity – the fabric of this country has been evolving. Sustainability has been brought to the forefront.

Just like ESG has evolved, we have evolved too in our thinking. Once thought to be simply a compliance check, as the original connotation was that ESG funds tend to underperform, has now seen tangible outcomes that have helped deliver alpha in portfolios. That is why ESG is an important part of our fundamental research. We believe that ESG helps produce alpha, but through a different lens relative to most. We believe it produces alpha by helping investors lose less – avoiding large losses.

We will admit, that at Aptus, our investment philosophy is not solely based on ESG. We understand that you need to make holistic decisions when fundamentally valuing a company. That is why it is an arrow in our quiver when intrinsically valuing companies through our "Compounder Mentality".

How Does ESG Impact Investment Analysis:
Investors need to continue to be pragmatic about their thinking. They need to evolve with the market, or else, they can fall victim to it.

At Aptus, we invest in companies that we believe are innovating. But it doesn't stop there – we look for compounders that have built a sustainable competitive advantage that are essential to their customer's needs. Furthermore, they are run by management teams that value the environment, the social fabric, all while maintaining some type of governance over the company. When companies embrace these characteristics, and focus on these issues with a long-term perspective, we believe it helps build long-term wealth.

Innovating in a manner where you can have a sustainable advantage that intersects with owning companies that are built to last. This is one of the core tenets on how we look to invest.

Where Does Aptus See ESG Evolving in the Upcoming Years:

In our opinion, it's simple – it's going to come down to more dialogue and engagement by companies. Over the last few decades, it was simply do not own alcohol, gambling companies, i.e., "Sin Stocks". That was the beginning of this movement. Now, there is more of a stakeholder appetite to address climate, diversity, and wealth inequality.

Not only having the conversation but bringing everyone along. Society isn't just some – it's everyone. There needs to be more dialogue than just screening out companies.

Where We Differ:

The ESG industry has grown and changed – we believe that it has moved from a "negative screening" to a more positive approach that favors good companies that can even improve society through shareholder advocacy and lobbying.

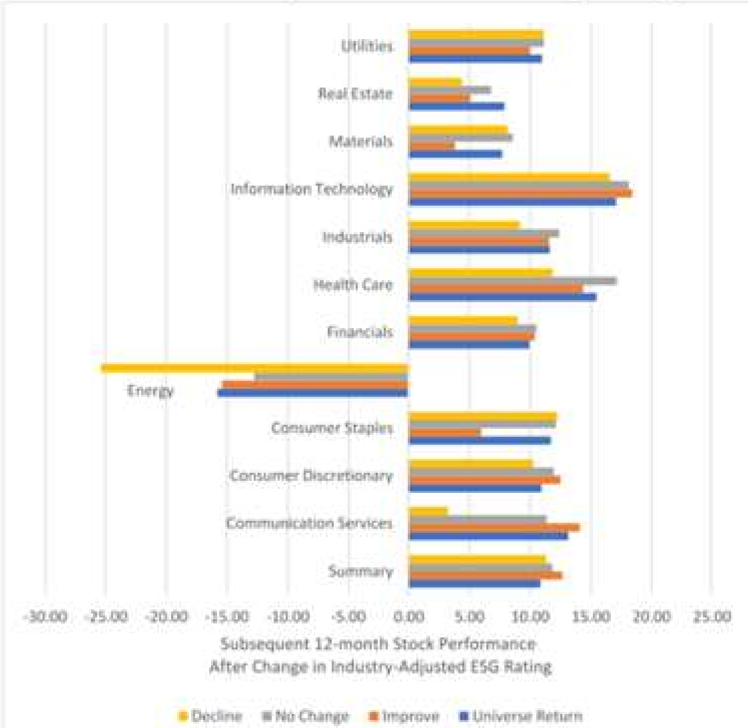
I wish we could claim this quote, but Michael Porter said, "the opportunity to create economic value through creating sustainable, societal value will be one of the most powerful forces driving growth in the global economy."

We know that sustainability is paramount to investing. Sustainability risks and opportunities are not a separate category of factors to be assessed, in our view. Rather, sustainability challenges are part of the reality in which we all live and operate. As investors, we must find the companies who understand these challenges and opportunities and continue to adapt to these realities to pursue long-term profitability.

And that's why we use ESG as an arrow in our quiver when we fundamentally analyze a company. It helps us reduce risk in our portfolio – you win by losing less and understanding the ESG makeup of a company can help us avoid large blow ups. For example, ESG does a great job mitigating bankruptcies - 15 out of 17 (90%) bankruptcies in the S&P 500 between 2005 and 2015 were of companies with poor Environmental and Social scores five years prior to the bankruptcies.

Furthermore, we've started to not just focus on companies that have, from what we believe, healthy ESG characteristics, but those that have been improving their ESG footprint. This can work as long as the multiple paid for "good" ESG stocks are not excessive and as long as the investor has high conviction that an ESG laggard is on the path to improvement. Energy stocks are a prime example of an industry that has started to revolutionize, holistically, their standpoint on ESG.

Exhibit 1 - Relationship Between ESG Rating Changes and Stock Performance



Source: BofA, Data as of 5/31/2021

<u>Conclusion:</u>

While many individual investors seek to incorporate sustainability considerations into their portfolios to align their investments with their values, we find that doing good no longer comes at the expense of doing well from a return standpoint. The difficult and more subjective part of this is that it increasingly requires something more nuanced and can take many different forms.

Society is inexorably moving in a direction that will demand sustainability—from consumers demanding sustainable products, to younger generations coming into management roles at companies in which we invest. In our experience, the best business leaders are long-term thinkers who are already acting on the threats and opportunities within ESG. While the next generation is known to be driving interest in sustainability, it is really the long-term thinkers, of all ages, in our view, who are leading the charge towards change.

Part 3: HNW Holdings ESG Breakdown

Description of ESG Themes:

Descriptions of Impact Themes:	
Economic Development and Social Inclusion:	
Affordable Housing	Offering housing options to low- and moderate-income families.
Economic Mobility and Community Development	Increasing employment opportunities and financial inclusion for underserved communities.
Education	Reducing barriers to education for underserved groups.
Diversity, Inclusion, and Equality	Supporting race and gender equity; empowering marginalized populations.
Health and Well-Being	
Health and Wellness	Promoting health and well-being and improving access to and quality of health care.
Clean Water and Sanitation	Improving access to clean drinking water and sanitation services; solving infrastructure challenges; managing freshwater ecosystems.
Environment	
Sustainable Technology Innovation	Innovating products and services that deliver sustainability results.
Efficient Production and Conservation	Reducing use of energy or raw materials, increasing use of renewables, etc., through internal operations.
Clean Energy	Developing, operating or delivering clean energy from wind, solar and other renewable sources.
Sustainable Agriculture and Natural Resource Management	Responsibly managing natural resources, minimizing or reversing land degradation, and protecting biodiversity.

Company Name (Ticker)	ESG Theme	ESG Rational
Adobe, Inc. (ADBE)	Sustainable Technology Innovation	An unparalleled leader in digital content creation (>50 billion documents a year) with a 20-year history of helping companies reduce resource usages. Adobe estimates that its document cloud leads to 90%+ cost savings from a lower environmental footprint per document vs. printing.
Alphabet Inc. (GOOGL)	Efficient Production and Conservation	Alphabet's sustainability efforts go far beyond its internal environmental efforts. Its custom-designed data centers are more energy-efficient than the industry average (a notable advantage as energy costs have become an ever-larger percentage of data center budgets). It has operated as carbon-neutral since 2007, and in 2017, it achieved 100% renewable energy for its operations.
Amazon.com, Inc. (AMZN)	Efficient Production and Conservation	A leader in e-commerce and in cloud computing services through Amazon Web Services (AWS). AWS auctions computation power in real time, allowing Amazon to more evenly distribute its servers' loads and process more data on less hardware. AWS enables secondary environmental and health benefits to customers (e.g., performing intensive simulations to streamline clinical trials, improving safety and reducing patient burdens). In 2017, Amazon acquired Whole Foods Market, a leading retailer of organic and natural foods (a category growing more rapidly than conventional food products).
American Tower Corporation (AMT)	Economic Mobility and Community Development	One of the largest wireless tower operators possessing what we consider a strong environmental compliance track record and a focus on using alternative energy in its remote tower base. Its work reducing carriers' dependence on highly inefficient generators has earned it a strong reputation in international markets and helped it gain market share.
The Home Depot, Inc. (HD)	Efficient Production and Conservation	A retailer of building materials and home improvement products with a growing revenue stream from environmentally sustainable product options; these have become the fastest-growing category in its product mix. It is also implementing systems to improve logistics efficiency, which has resulted in reduced truckloads and significant cost savings.
CHEMED Corp. (CHE)	Health & Wellness	While CHEMED represents a small part of health care spending, its services play what we view as a substantial role in the hospice industry, contributing to relieve suffering, promoting dignity, and facilitating closure for patients and families through end-of-life care – all improving overall health care costs.
Broadridge Financial Solutions, Inc. (BR)	Efficient Production and Conservation	A service provider with a growing revenue stream from environmentally sustainable product options for its customers through its Investor Communications segments, which will continue to help minimize the carbon footprint from the market's antiquated proxy voting system.
JPMorgan Chase & Co. (JPM)	Economic Mobility and Community Development	Business development has an important role to play in advancing the transition to a low-carbon economy. JPMorgan Chase had made a commitment to their clients to help navigate the challenges and capitalize on the long-term economic opportunities and environmental benefits of progressing toward a low-carbon world. We believe they have capital, data, expertise, and other resources to help address climate change and promote long-term, innovative solutions for a more sustainable future.

Dollar General Corp. (DG)	Economic Mobility and Community Development	This leading low-price retailer of household products proudly reinvests in the communities that they call home, which many tend to be in underprivileged areas. Not only is Dollar General a good steward to their communities, but they have extensive policies to reduce their environmental aiming to find sustainable alternatives for the single use plastic bags.
Fidelity National Information Services (FIS)	Economic Mobility and Community Development	We believe Fidelity National's products help customers advocate for financial inclusion as they know this begins with giving people access to the tools and support they need to grow financially, to empower themselves, their homes and their communities.
Roper Technologies, Inc. (ROP)	Efficient Production and Conservation	Roper takes measures to help their manufacturing, transportation and waste disposal activities aim to be consistent with the protection and preservation of the environment. Environmental stewardship applies to many areas of their business operations from recycling inbound material to the engineering of their solutions and elimination of waste in delivering these solutions to their customers.
NVIDIA Corporation (NVDA)	Sustainable Technology Innovation	NVIDIA is a global high-performance semiconductor technology company. A leading GPU semiconductor provider of high-performance, application-specific products in data centers, networking, and connectivity. Their recent acquisition is a pioneer in designing processing systems as they were an early adopter of the energy efficient ARM-based systems.
Copart, Inc. (CPRT)	Efficient Production and Conservation	Copart engages in many programs that have a positive effect in reducing their impact to the environment. These programs, which we believe are the cornerstone of responsible equipment management, helps them reduce the quantities of liquid and solid waste they generate.
UnitedHealth Group, Inc. (UNH)	Health & Wellness	UnitedHealth Group (UNH) provides health care coverage, software, and data consultancy services. Its Optum software provides customers with analytical insights that help drive increased quality and efficiency in the health care system, enabling customers to reduce costs and patient health risks, improve clinical performance and patient outcomes, and adapt to the changing health system landscape.
Visa, Inc. (V)	Economic Mobility and Community Development	Visa's electronic transaction network gives emerging market populations access to electronic financial services via mobile phone that would otherwise be unavailable. This global payments system is a key ingredient in improving the flow of goods and services in emerging markets, ultimately creating major societal benefits, as well as a powerful platform for future growth.

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