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Ethics in Stock Picking

Dear fellow investors,

A truly interesting contradiction is developing in stock markets around the world. A number of major corporate executives are calling for businesses to be judged by something other than the net present value of their future earnings or other conventional business/investment metrics. This comes under the heading of ESG, which stands for environmental, social and corporate governance. The idea is measuring how good businesses are in ethics, for society, as well as for future profits.

The problem mostly lies in the agenda surrounding whoever sets up the ESG screen and the number of screens that exist. Here is how Akane Otani of *The Wall Street Journal* described it on February 10, 2020 in an article titled Big Technology Stocks Dominate ESG Funds: "The data point to one of the biggest frustrations critics have about the world of socially conscious investing: There is no industrywide rulebook to determine what should go into ESG funds."

What stirred this subject up was the announcement on February 4, 2020 that Merck (MRK) was going to spin out a public company made up of a number of their profitable medicines. The purpose is to focus the parent company on a narrower group of cures mostly related to their dominance in cancer research and immuno-oncology. Merck said they wanted to improve their focus on their work surrounding medicines like Keytruda, which treats lung cancer.

In an explanation of this move in *The Wall Street Journal*, writer Charley Grant focused on the riskiness and represented the Wall Street research analyst community well. The stock fell sharply in reaction. If your relative has a cancer other than lung, do you consider what Merck is doing as risky? Why in a supposedly ESG world would focusing in on expanding the number of curable cancers be anything other than great news? Keytruda is already a massive blockbuster for treating lung cancer and it is the prayer of cancer patients and families that the success will spread to the other four major cancers. What could be better for society?

Here is the contradiction. So far, ESG has focused heavily on the E (environmental), the gender equality in S (social) and the board work in the G (governance). Most ESG investors have fallen all over themselves to own the environmentally friendly (pollution-less) FAANG stocks (Facebook, Amazon, Apple, Netflix and Alphabet) and have forgotten some of the social and governance aspects. Otani explains, "Some fund managers screen out all companies from a certain industry, like oil and gas, and focus on smaller, lesser-known firms at the forefront of areas like clean energy or boardroom diversity. That risks delivering returns that may drastically trail behind the broader market. So the institutions behind the biggest ESG funds often follow another playbook: They try to minimize how much their fund deviates from the broader market by creating a portfolio that, for the most part, looks like today's technology-dominated S&P 500—just stripped of the companies with the worst ESG practices within each industry."

Therefore, for most ESG benchmarks, they are just piling into the same growth-oriented overweight that has been so popular and looks just like the S&P 500 Index. Just what we needed, another set of agnostic investors not participating in setting prices.

Beside the senseless agnosticism of more index piling, there is serious social and governance issues with the non-polluting FAANG stocks. Is it acceptable to get rich polluting mostly male minds and destroying marriages by web hosting the pornography industry? This hurts women much more than men, historically. It seems in ESG it is fine pitting us against each other in social media while promoting depression and loneliness. It appears to be no problem poisoning our political discourse as long as you don't pollute the environment and have a female second in command.

We can go on. Destroying privacy, manipulating teenage lives and competing unfairly through social media or search monopolies or free delivery at a loss seems good for these ESG folks as long as you don't pollute the environment and/or have the right board representation.

In the Bible, Hebrew prophets, Jesus and his disciples healed people to promote faith in God. Is it not admirable to get rich ending the misery and heartache of dear friends and relatives to cancer? Women get 97% of the breast cancers and 100% of ovarian cancer. I have spent 40 years in the investment business, and this is the first era when miraculous new medicines haven't caused the stocks of medicine makers to soar! Are we missing something?

Sir John Templeton, one of the all-time great stock pickers, was the most popular guest in the history of the popular PBS show, "Wall Street Week" with Louis Rukeyser. Almost every time he appeared, he said nearly the same thing, "Louis, the medical discoveries of the next ten years will exceed everything we found the last 30 years!" He has been consistently correct. Send us an email if you've had a friend or relative positively impacted by immuno-oncology. Go visit Sloan-Kettering or The Mayo Clinic or MD Anderson or the Fred Hutchinson Cancer Research Center and tell me you are not excited or amazed. Before Sir John Templeton died, he set up a foundation which promotes ethics in investing and business.

Merck trades for a reasonable 15.35 forward price-to-earnings ratio and pays a juicy dividend. To us, their governance is fantastic because their board has close ties to the top medical research organizations and their conservative accounting causes them to expense their largest long-term investment, research and development (R&D). This causes earnings to be lower than companies that depreciate their important long-term investments.

Netflix is using eight years to depreciate the movies they are producing even though 150% of them won't get watched two years from now. In the streaming world, the billions of dollars spent on script writing is so rushed that great actors and actresses are forced to repeat extremely foul language, rather than saying something intelligent. Does every parent want their kids growing up using offensive language? Aren't they polluting people's minds? If Merck depreciated R&D over eight years, it would reduce their annual expense by 80% the first year.

Stock picking is an industry which is difficult to compete in, and if it wasn't, the rewards wouldn't be what they are. Merck looks especially attractive relative to history, because it trades in a stock market where companies with as wide a moat, as good of a balance sheet, as high a return on equity and as good of forward growth prospects all trade for 20-30 times earnings. However, if ethics are going to be included in stock market analysis, there needs to be a huge movement by most ESG investors to do their research and get real about the obvious contradictions in the stock market.

Warm regards,

William Smead