Cornerstone Capital Group

Global Thematic Research

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The Art of the Possible: Investing to Address Inequality

In this report we identify investment opportunities that offer competitive financial returns while helping to address concerns about increasing levels of inequality and income stagnation.

The rise of populist and anti-globalization political movements in the developed world is in part a reaction to middle-class wage stagnation and inequities based on age, race, gender and geography. The increasingly popular belief that the global economic system does not serve the interests of all is a source of social tension and political upheaval, creating long-term risks for investors.

Middle-income workers in developed countries face rising economic pressures:

- Globalization and automation have benefited economic elites and workers in some developing countries while contributing to wage stagnation for many developed country workers.
- Decreasing returns on investment in education are reducing opportunities for economic mobility in the US.
- The prices of certain necessary goods, like college, medical care and shelter, have increased relative to wages.
- Inequality is becoming more pronounced among younger people, potentially hampering their long-term economic mobility. The percentage of US households earning a middle-class income has decreased.

Age, geography, gender and race further limit upward mobility for many groups of people. For instance, the likelihood of a low-income child in the southeast US achieving a high income in adulthood is notably less than for rest of the country.

Populist and nationalist movements are pledging to reverse these trends for some groups or all, sometimes gaining support by exploiting social tensions associated with these inequities. Such a response to globalization might exacerbate social tension and do more harm than good to the economic and political foundations for prosperity in the developed world.

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A number of sustainable investment strategies exist to address inequality

Investors can address concerns about inequality responsibly by selecting managers who employ a number of sustainable investing strategies. Inequality cannot be addressed without supportive public policy. Yet, investors can still make a substantial impact through certain strategies such as:

- **Proxy voting and corporate engagement.** Investors have a voice in company policy through their equity ownership stake, on issues such as equitable compensation policies, improved diversity and fair labor policies.
- **Investing in fixed income instruments to support investments in communities.** A small group of fixed income funds offers market rate returns supporting affordable housing and social and environmental infrastructure. These funds can be targeted geographically and thematically.
- **Affordable housing or other real estate funds.** Affordable housing funds offer an avenue for investment that provides subsidized housing and links residents to social services while still earning market returns for investors.
- **Private debt strategies.** These funds finance small businesses and other organizations in underserved communities. Some low-risk/low-return vehicles lend directly to small businesses and non-profits in low-income areas to provide services in underserved communities.

Income inequality

Economic anxiety proved to be a key factor in the 2016 US elections, the earlier "Brexit" vote in the UK, and other political developments favoring populist and sometimes nationalist political parties across the developed world. Widening income inequality, wage stagnation, and shifting economic relationships all have contributed to a growing distrust of globalization and global institutions, a distrust shared by people of varying demographics and political orientations.

Many people across the US no longer believe that the global economy serves their interests

Many people across the US no longer believe that the global economy serves their interests, a view in common with many residents of the UK, Europe and Australia, where populist movements have also gained traction. Some have characterized the election of President Trump and Brexit as a rejection of the global economic system by those who feel (rightly or wrongly) excluded from its benefits. There is a real danger that the reaction to globalization, unless thoughtfully managed, might do more harm than good to both economic policy and democratic politics.

In addition to fomenting political upheaval and undermining confidence in democratic capitalist systems, income inequality poses a serious risk to prosperity. With costs of basic goods and services such as housing, education and health care continuing to rise, discretionary income to drive consumer demand becomes concentrated in too few hands, threatening to choke off further economic growth.

Given the changing landscape of government policy under the new administration, private sector efforts to mitigate the effects of income inequality may play an increasing role in the coming years. For investors looking to slow or even reverse the growing disparity, we see a range of investment opportunities that combine social and financial returns to make a long-term and sustainable impact against the increasing levels of inequality.

Global income trends

Global economic progress leaves developed country working classes behind

The parallel and complementary trends of globalization and automation have shifted the distribution of income across the globe. Many newly employed people in the developing world and economic elites whose productivity has dramatically risen have enjoyed rising incomes. Incomes among workers in rapidly developing countries, especially in China and India, rose 80% between 1988 and 2008 as a result of technological advances and a more global supply chain. The top global percent by income were also advantaged by these trends, with incomes increasing 60% over the same time period. [1]

Incomes across educational levels in the developed world have stagnated for all but a small cohort of highly skilled workers in certain industries

A large share of workers in the developed countries, now competing with a global workforce as well as computers and robots, have not shared in the benefits. Incomes across educational levels in the developed world have stagnated for all but a small cohort of highly skilled workers in certain industries, while many workers have not been able to remain consistently attached to the workforce at all.

The result is growing anxiety among developed country population, and an assumption among some people that the gains that some have made have come at their expense.

US incomes stagnate while necessities become less affordable

Education alone may not be enough to lift incomes broadly

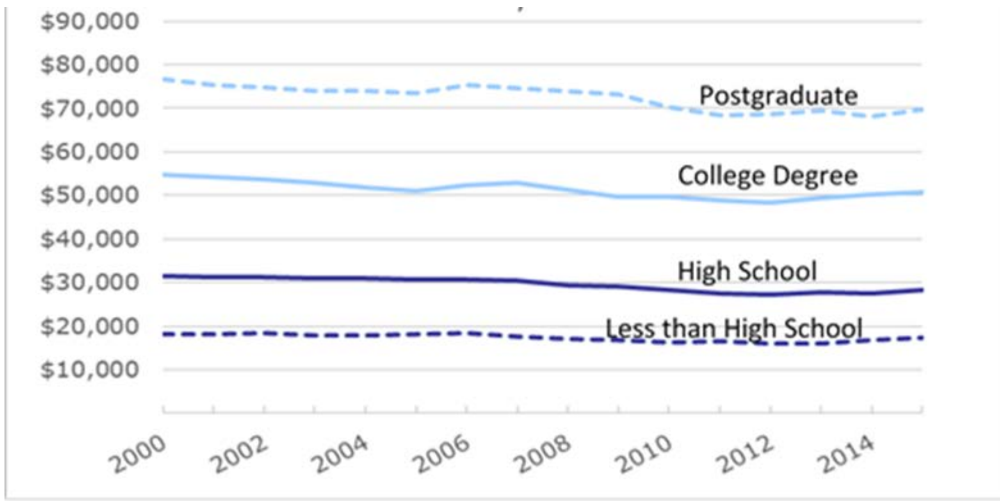
As Figure 1 demonstrates, US median incomes for all education levels (adjusted for inflation) declined between their peak in 1999 until 2015. It is an

[1] Global Income Distribution: From the Fall of the Berlin Wall to the Great Recession, Christoph Lakner & Branko Milanovic, World Bank Econ Rev (2015) 30 (2): 203-232.

encouraging sign that incomes increased markedly in 2015, but whether this is a sustainable trend is not yet clear. Nevertheless, the long-term trend suggests that education alone will not be enough to lift incomes broadly.

Moreover, while overall inflation remains restrained, the relative price levels of different categories of consumer spending have diverged widely.

Figure 1: Median real income by educational level in the US, 2000-15



Source: Cornerstone Capital Group, US Census Bureau. Adapted from "Inequality and Modernization: Why Equality Is Likely to Make a Comeback," By Ronald Inglehart Foreign Affairs, Jan/Feb 2016

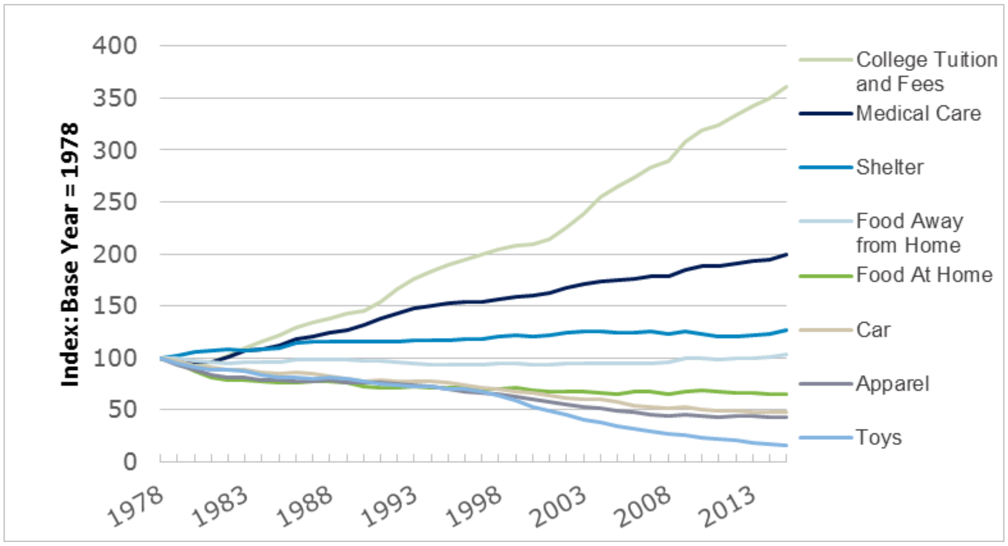
Figure 2 shows that certain goods, especially those manufactured items most affected by global trade and automation, have become relatively more affordable, while "non-tradable" items such as education, medical care and housing have increased substantially – for instance, the cost of education has risen more than 350% faster than inflation as a whole.

As incomes are increasingly dedicated to non-discretionary spending, poorer populations struggle to save, create wealth, and achieve economic mobility

College tuition, healthcare and shelter cannot be trimmed easily without major consequence, either because they are bound by long-term contracts or because they are critical for quality of life in modern society. As incomes are increasingly dedicated to non-discretionary spending, poorer populations struggle to save, create wealth, and achieve economic mobility.

Concerns over availability of education, healthcare and housing may cause individuals and families to feel at heightened risk of job or income loss, especially while memories of the financial crisis and great recession remain fresh. Many people may also perceive these pressures to be more significant to their lives than the benefit of access to more and cheaper goods.

Figure 2: Change in prices of goods and services relative to overall price change



Source Timothy Lee, Vox.com, FRED, Cornerstone Capital

A tale of two countries: The disappearing middle class

Despite incomes stagnating *on average*, US incomes are becoming more concentrated in the lower and upper strata. Figure 3 demonstrates a Pew Research Center Study that shows the proportion of middle-income people compared to lower-income (less than two-thirds of median income) and upper-income (more than twice the median income).

Some highly educated professionals are enjoying substantial income gains, while the proportion of lower-income households is also increasing, in part because more prime-age men have dropped out of the labor force. The result is a “hollowing out” of the middle class: from 2000 to 2014, the share of middle-income households decreased by 7%.

This change is primarily a consequence of unequal distribution of economic growth, rather than slower overall economic growth

The study concluded that this change is primarily a consequence of unequal distribution of economic growth, rather than slower overall economic growth. The result implies that reducing inequality would be a more effective strategy for increasing incomes than boosting growth. However, the data suggest that the opposite may be occurring: inequality may be rising in younger generations as compared to older generations. We examined how the wealth in the younger generation is distributed.

Figure 4 shows that the bottom 50% of each age group owns a disproportionally small share of the total age group's wealth while the top 10% receives a disproportionately large share of the total age group's wealth.

The under-35 age group exhibits this trend to an extreme: the top 10% hold 69% of all the wealth owned by under 35s while the bottom half have negative-11%, which is possible only because this group holds more debt than wealth overall. Intra-generational inequality is significantly more pronounced for younger Americans than those of older generations.

Figure 4: Wealth distribution within age group (2013)

Source: Source: Federal Reserve Survey of Consumer Finances, DQYDJ, Cornerstone Capital

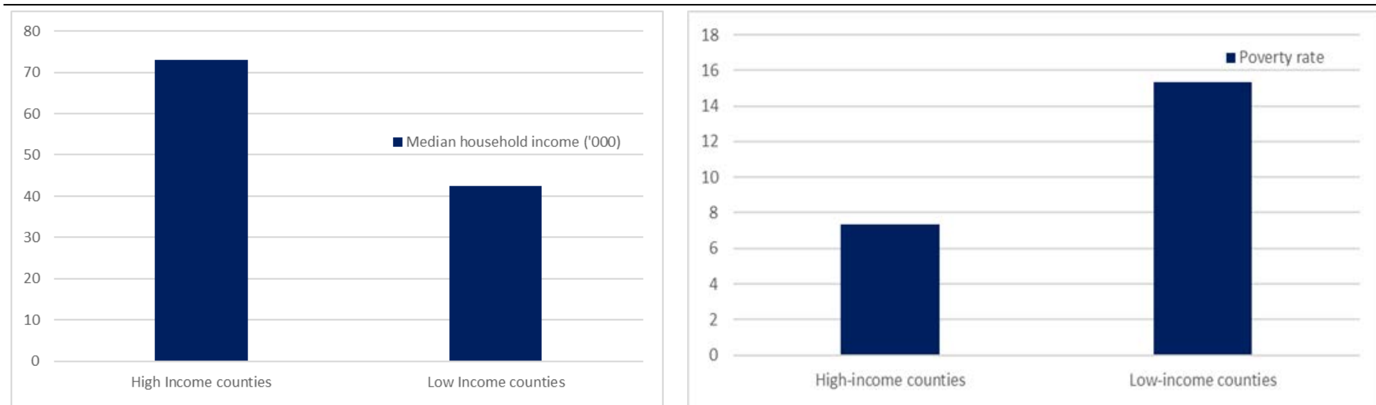
This trend could reverse later in life, but the experience of older age cohorts suggest that inequality trends do not change much throughout life. More likely, inequality is being entrenched earlier on and becoming harder to reverse. If raising incomes depends on reducing inequality, then an increasing standard of living may be hard to reach for young Americans. These individuals may perceive that they have little incentive to support market-based institutions, or to participate in an economy that is not likely to reward them.

Geographic inequality[3]

The potential to achieve the American Dream also depends on where one lives. One-third of Americans live in high-income counties, where the median household income is approximately $73,000. Another third live in low-income counties (Figure 5), whose median household income is over $42,000, just 57% of the high-income counties. Inequality between counties is most pronounced within the high-income group, whose incomes range from $57,000 to $123,000.

High-income counties tend to be larger, more densely populated cities and suburbs (median population 250,000), while low-income counties tend to be smaller, more rural or exurban counties (median population 53,000), though the largest cities are not necessarily the richest.

Figures 5 & 6: Median income and poverty rate, disparities by locale (average 2011-2015)



Source: US Census Bureau, Cornerstone Capital Group

Job growth has become more concentrated in larger, more affluent urban and suburban locations while the number of businesses in rural areas has fallen

Regional inequality may be muted somewhat by different regional cost of living rates, but the economic experience of living in these "two Americas" differs significantly. Poverty rates are more than double in low-income counties relative to high-income counties (Figure 6). Moreover, employment opportunities diverge substantially between high- and low-income counties. New businesses and job growth, once widely dispersed across the country, have recently become more concentrated in larger, more affluent urban and suburban locations while the number of businesses in rural areas has actually fallen since the great recession.[4]

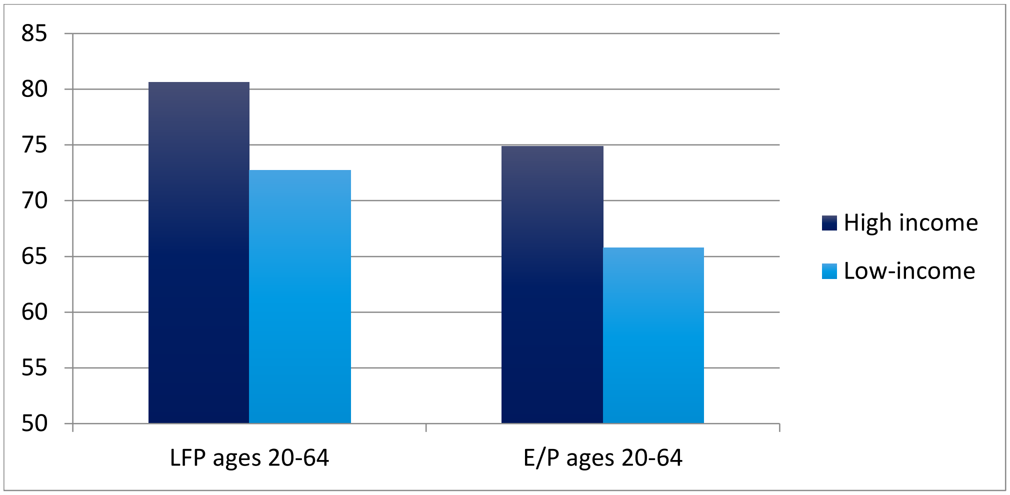
Across high-income counties, the unemployment rate from 2011-15 (a period when unemployment fell across the US) averaged 6.44%, while in low-income

[3] Except as noted, data in this section is drawn from the US Census Bureau, American Community Survey, "Selected Economic Characteristics, 2011-2015" www. Census.gov

[4] http://eig.org/recoverymap

counties unemployment averaged 8.99%. Many economists believe that the official rate understates joblessness because it counts only those actively seeking work. Two other measures, Labor Force Participation rate (LFP; the proportion who have or are actively seeking jobs) and the Employment/Population ratio (E/P) attempt to more accurately portray the percentage of the population that either has or desires a job. High-income counties currently employ nearly 10% more of their populations than low-income counties, while the labor force of high-income counties is approximately 8% higher than in low-income counties.

Figure 7: Employment, by locale (average 2011-2015)



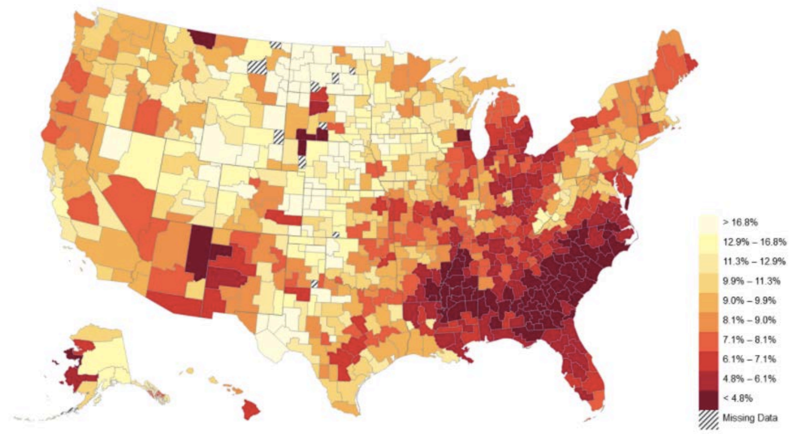
Source: US Census Bureau, Cornerstone Capital Group

The data provide evidence that there is a substantial population of people in low-income counties that have become discouraged from seeking work.

Particularly concerning is the possibility that the trend of declining incomes and welfare in some parts of the country will become self-sustaining. Figure 8 shows the likelihood that a child growing up in a low-income (bottom 20% of income earners) household will eventually reach high-income (top 20%) status. The map illustrates the disparity in this likelihood depending on location: from less than a 5% chance in some places to over 16% in others. While this map does not precisely correlate to the high- and low-income counties described above, economists generally agree that mobility in high-income areas exceeds that in low-income areas.

People who live in communities where the common experience is one of economic struggle, poverty and unemployment may come to doubt economic news of growth and development, or develop resentments of other communities who are reaping benefits denied to them.

Figure 8: Chances of children reaching top 20% of income distribution given parents in bottom 20%



Source: The Equality of Opportunity Project

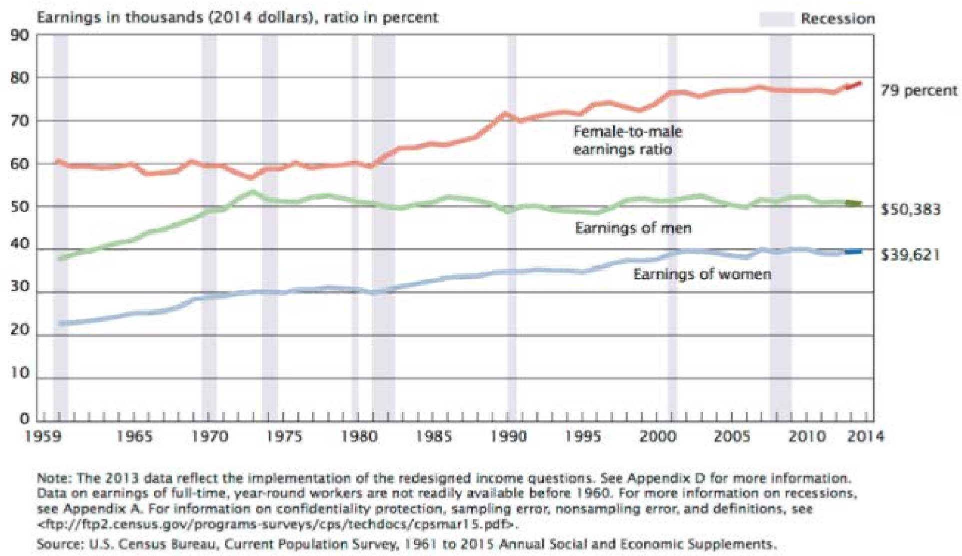
The gender pay gap

The current economic environment poses distinct challenges for men and women. For women, pay levels remain below those of men despite decades of progress. For men, both pay levels and workforce participation are in decline.

Social and economic changes have reshaped the gender composition of the US workforce. Male (ages 25-54) participation in the labor force (either holding a job or looking for one) has decreased from 97% in the 1950s to less than 90% today. Female labor force participation increased from 30% to 75% over the same period.

Moreover, US women have seen their incomes grow as cultural attitudes toward women in the workforce have evolved. Since 1959, the average earnings (in constant dollars) of women have nearly doubled and their income has risen from 60% of men's to nearly 80% today. Some of those gains, however, have come at a time when men's earnings have been stagnant or declining; male earnings peaked in the early 1970s and have been slowly sliding ever since. Yet women still have not achieved pay parity in the workplace.

Figure 9: Female-to-male earnings ratio and median earnings of full-time, year-round worker 15 years and older by sex: 1960-2014



Source: US Census Bureau

Increased automation and a more global supply chain drove much of the disproportionate drop in male employment

Increased automation and a more global supply chain drove much of the disproportionate drop in male employment by eliminating many jobs requiring only a high school diploma. There is risk that women may undergo a similar experience: As Cornerstone analysts concluded in our recent report Women in an Automated World, the next wave of workplace automation is set to disproportionately affect "women's" jobs[5]. Meanwhile, those traditionally "female" jobs that are relatively safe from the threat of automation tend to pay less than less-threatened "male" jobs.

Although the absolute aggregate economic circumstances of men remain healthier than those of women, the convergence of lower incomes and lower labor force participation may cause some men to question (incorrectly, in our view) whether improvements in women's income are coming at the expense of men's income, and whether the traditional cultural role of men as primary breadwinner is being usurped. At the same time, many women may be frustrated by the slow pace of change and the possibility that automation may reverse some of the gains that they have made.

[5] We define female- and male-dominated occupations as those in which women account for more or less than 50% of employment, respectively.

Racial inequities

There is a strong and persistent economic inequality along lines of race and ethnicity, particularly with regard to African-Americans and Latinos. An extensive literature discusses these trends in depth. We can add little insight to the existing research, but it is worth taking note of these realities alongside other forms of economic inequalities.

African-American households earn on average 59% of the income of white, non-Latino (WNL) households.

African-American households earn on average 59% of the income of white, non-Latino (WNL) households.[6] Latino households earn approximately 75% of WNL households. (Asian households out-earn WNL households by about 23%.) The US Census bureau observes that these ratios have not changed meaningfully since the 1970s.

Unemployment rates among working age African-Americans are double those of WNL adults, while Latinos have approximately 40% higher unemployment than WNLs.[7] Some scholars attribute this disparity in part to disproportionate incarceration rates for African-Americans in particular, relative to others.[8] Felony convictions are well understood to substantially reduce lifetime employment opportunities.

Homeownership rates for WNL, African-American and Latinos respectively are 73%, 45% and 47%.[9] Racial discrimination in the mortgage market continued at least as recently as the 2002-2007 housing bubble.[10]

34% of WNL adults have college degrees, compared to 20% for African-Americans.[11] Racial disparities persist in secondary education as well.[12]

Moreover, multiple studies have demonstrated that African-Americans in particular receive substandard healthcare relative to other groups.[13] However, the enactment of the Patient Protection and Affordable Care Act ("Obamacare") reduced these inequities somewhat.[14]

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6 http://www.census.gov/content/dam/Census/library/publications/2016/demo/p60-256.pdf
7 https://www.bls.gov/web/empsit/cpsee_e16.htm
8 http://newjimcrow.com
9 http://www.census.gov/housing/hvs/files/currenthvspress.pdf
10 https://www.washingtonpost.com/news/business/wp/2017/01/18/justice-department-sues-jpmorgan-chase-for-mortgage-discrimination/?utm_term=.96ecc4e4ff91
11 http://www.demos.org/sites/default/files/publications/RacialWealthGap_1.pdf (see page 2)
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14 https://www.ncbi.nlm.nih.gov/pmc/articles/PMC4711386/

Options for investors

For investors looking to contribute to the slowing or even reversal of the growing disparity, we see a range of investment opportunities that combine social and financial returns to make a long-term and sustainable impact against the increasing levels of inequality.

There are a growing number of investment managers and strategies for which income inequality is a serious concern. These portfolio managers generally take a longer-term view and look at how a company is contributing to long-term economic growth, with the view that more growth ultimately supports the business.

Managers will have different views on how to address this in their portfolios, especially relative to other financial, social and environmental concerns.

Public equities

In a previously published report Income Inequality: Market Mechanism or Market Failure, Cornerstone Capital identified ways to integrate income inequality considerations into equities investment. The key takeaways include:

1. Investors can vote and advocate for more equitable compensation plans and policies for management. An increasing number of investment managers consider these issues a priority when engaging with companies.

Certain investment managers are paying closer attention to the longer-term investment priorities of a firm

2. How a company invests its capital is an issue that can be evaluated by investment managers to help select portfolio companies. While share buybacks generally benefit shareholders in the short term, certain investment managers are paying closer attention to the longer-term investment priorities of a firm, including benefits and wellness for employees, where and how the firm pays taxes, and long-term investment in research and development.

Investors can also assess the external impacts of a company's products and services on economic development

3. Investors can also assess the external impacts of a company's products and services on economic development. There are investment strategies that focus on a thematic approach in which companies are selected for the portfolio based on the social and economic benefits of their products and services. For instance, from 2008-12, Intel's business resulted in a combined $214.6 billion in income for its own labor force and those indirectly involved in development and production. The total impact on US GDP was estimated to be $408.5 billion.

Moreover, while declining perceived legitimacy of the global economic system may be an important symptom of growing economic anxiety, disruptions of longstanding economic relationships may cause other kinds of pressures relevant for public companies. Investors should be asking companies whether their sustainability and governance policies enable them to effectively respond to sharper differences of opinion among their own stakeholders.

Fixed income

A small group of fixed income funds offer market rate returns supporting affordable housing and social and environmental infrastructure for taxable or tax-exempt investors

A small group of fixed income funds offer market rate returns supporting affordable housing and social and environmental infrastructure for taxable or tax-exempt investors. At certain levels of investment, these funds can be targeted geographically and thematically. For instance, funds can target schools and hospitals and/or affordable housing in a specific metro region, helping to facilitate greater economic growth and distribution. These managers generally report to investors the impacts of these investments, including, for example, jobs created and houses constructed.

Alternatives

Affordable housing funds offer an avenue for investment that provides below-market rate housing and links residents to social services but still provides market returns for investors

Affordable housing funds offer an avenue for investment that provides below-market rate housing and links residents to social services but still provides market returns for investors. For instance, a particular fund manager appoints a social services coordinator for each of the properties it acquires. This manager connects residents with health and education services as well as developing internal programs and initiatives to improve the health and well-being of the residents. Innovative managers are also pursuing partnerships with community organizations to better understand and report the positive social impacts of providing affordable housing.

Other real estate funds seek to redevelop urban properties

Other real estate funds seek to redevelop urban properties with a mix of small businesses (such as healthy food-related enterprises), affordable housing, market rate housing, and offices for community organizations. These funds integrate access to public transport and the use of green building materials in their projects to encourage further positive social and environmental impact.

Private debt strategies exist with different risk/return profiles. Some low-risk/low-return vehicles lend directly to small businesses and non-profits in low-income areas to increase opportunity in underserved communities. Investors can choose CDs, deposits in a community bank or credit union, or CD-like instruments offered by a number of impact-oriented investment managers.

Riskier private debt instruments have similar strategies (loans to small businesses in underserved areas) but higher expected returns as the investor takes on more risk because of the characteristics of the loan itself or the borrower.

Asset Allocation

Our asset allocation recommendations, and our manager recommendations, are tailored to each clients' needs. For impact-oriented clients seeking market rate returns, there are numerous ways to enhance the positive social impact of a portfolio across asset classes. We believe in the opportunity for impact and risk-adjusted returns as the role of private investment becomes ever more critical in responding to income inequality.

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Cornerstone Capital, as an investment advisor, helps clients target their investments for competitive risk-adjusted returns based on their financial objectives and values, including social impact. We help clients find investments that meet their needs, and provide reporting and asset allocation services that integrate clients' mission and values into their investment portfolios. Investing in mitigating income inequality is a complex process but through professional guidance, investors can have positive financial returns while influencing a critical social and economic issue.

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