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Can stock be a sin?

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Abstract

Investments in stocks should increasingly satisfy ethical criteria. But what this means changes over time. Investors may therefore forego returns.

Zusammenfassung

Investments in Aktien sollen zunehmend ethischen Kriterien genügen. Doch was das darunter zu verstehen ist, wandelt sich im Laufe der Zeit. Investoren verzichten deshalb möglicherweise auf Rendite.

Equity analysts are generally a notoriously optimistic lot - they tend to see the companies they cover in a positive light rather than a bad one. Buy recommendations or so-called "outperformer" ratings are therefore the rule. But it is rather rare for a company to receive a positive vote from 24 of the 29 responsible analysts. Especially when it is a so-called *sin stock*. A stock of a company that does not meet the moral standards of the (financial) world - at least not in the present time.

But this does not seem to bother the 29 analysts who currently rate the Shell oil company: None of them holds a negative equity rating for the now purely British company, which only recently shed its additional name Royal Dutch. Now, no one should uncritically adopt analysts' assessments (whether the stock is suitable for an investor's portfolio is another matter, and such an assessment requires more than a positive analyst consensus), but oil and gas stocks have generally proven to be a good idea, at least this year: Simply because they achieved high gains.[1]

Companies should be above reproach

A good performance for a short time is one thing, but a closer look is another. *Sin stocks* are under special observation. As never before, papers from sectors considered sinful are affected by banishment - at least that is how it seems.

While this has traditionally always applied to stocks of companies in the so-called adult entertainment sector, gambling operators, arms manufacturers, tobacco and alcohol producers, oil companies have long since joined the ranks of stocks worthy of banishment. And there they still meet the companies from the biotech and pharmaceutical sectors, which are also traditionally viewed critically.

At a time when supposedly environmentally friendly, socially upright companies led by management that is hopefully above reproach are to be favoured, the question arises as to how stocks from sectors of sin compete in terms of returns.

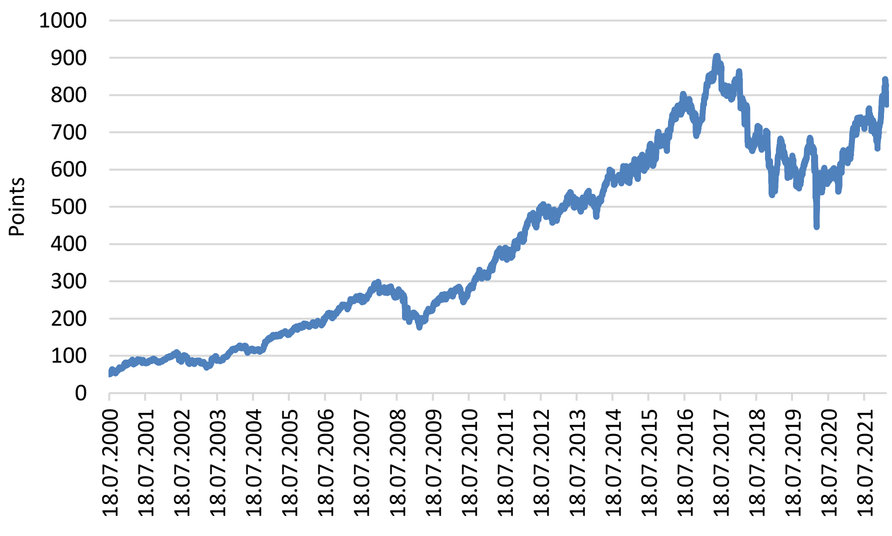
[1] Thomas Mayer, Stock of Sin, March 2022; https://www.flossbachvonstorch-researchinstitute.com/de/kommentare/aktien-der-suende/

Banned from portfolios

The effects of the ban have long been visible in the portfolios. Norway's largest pension fund KLP, for example, divested itself of companies involved in the alcohol and gambling industries: A revenue stock of 5.01 per cent in "sinful business" was enough to eject them from the portfolio. Pornography was already excluded from the pension fund's portfolio, as were companies that generate revenues from cannabis. And tobacco stocks have not been in KLP's portfolio since 1999.

The pension fund manages the retirement assets of about one million public sector employees. The general renunciation of individual sectors has also proven to be a renunciation of performance. Since the summer of 2000, for example, tobacco stocks have yielded a return of 1440 per cent (including taxes and dividends), while stocks in defence manufacturers have increased investor investment almost exactly sixfold since then (charts 1 and 2). Meanwhile, the comparable S&P 500 Net Total Return has only gained 288 per cent.[2]

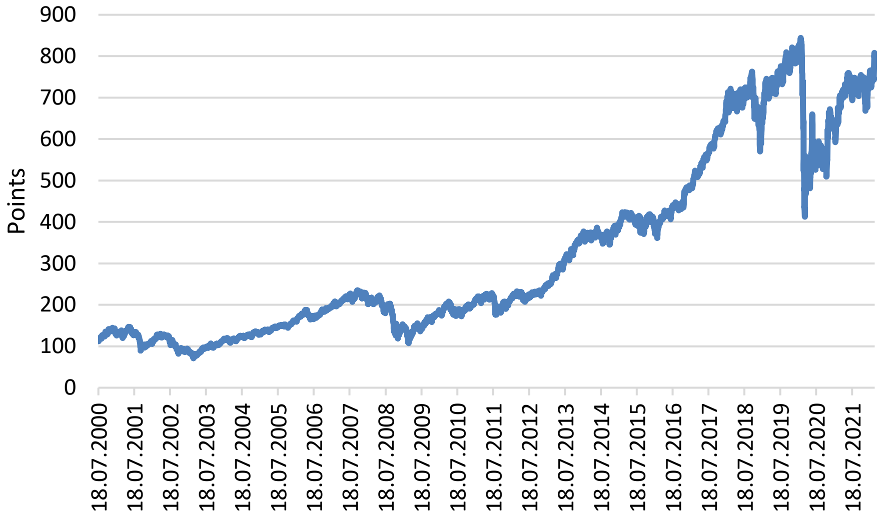
Chart 1: MSCI World Tobacco Net Total Return Index



Source: Bloomberg, as of March 2022. **Historical performance is not a reliable indicator of future performance.**

[2] The indices used in this analysis are: MSCI World Tobacco Net Total Return Index, MSCI Aerospace & Defence Net TR Local Index, MSCI Integrated Oil & Gas Net TR USD, MSCI World Pharmaceutical Net Return Index, MSCI ACWI Biotechnology Net Total Return Index, Nasdaq CRB Monitor Global Cannabis Net Total Return Index, STOXX Sustainability ex Alcohol Gambling Tobacco Armaments & Firearms Adult Entertainment Net Return USD, S&P 500 Net Total Return Index, S&P Total Return (chart 6 only).

Chart 2: MSCI Aerospace & Defence Net Total Return Index



Source: Bloomberg, as of March 2022. **Historical performance is not a reliable indicator of future performance.**

Even compared to indices that exclude, for example, weapons, alcohol, tobacco, adult entertainment and gambling, tobacco or arms stocks do well. A broad index of the provider STOXX, which excludes companies from precisely these "sinful" industries, has gained 223 percent since the beginning of 2001 (chart 3).

By way of comparison, the S&P 500 Net Total Return provided investors with more than double the value growth over this period, at plus 452 percent. Tobacco stocks (plus 872 per cent) or armaments (plus 446 per cent) also beat the index, which was compiled from a moral point of view, by far over this period.

Chart 3: STOXX Sustainability ex Alcohol, Gambling, Tobacco, Armaments & Firearms, Adult Entertainment, Net Return Index USD

Source: Bloomberg, as of March 2022. **Historical performance is not a reliable indicator of future performance.**

But even if pension funds or index providers rely on morally impeccable investments, this does not answer the fundamental question: What is sin in the first place? Depending on the religion, for example, the answer varies, but it is usually clearly defined in the corresponding scriptures.

Beyond that, in a secular context, it quickly becomes fuzzy. The English writer Gilbert Keith Chesterton ("Father Brown") wrote: "Morality, like art, consists in drawing a line somewhere."

Smoking as a lifestyle

Anyone who has passed midlife should already be aware that this line is sometimes shifted here, sometimes there, depending on the spirit of the times. For example, the consumption of cigarettes was considered socially acceptable for a long time. "Light" (cigarette) tobacco consumption was once even welcomed over "heavy" (cigar) tobacco consumption.

During the First World War, every German soldier (in the field) received tobacco products as part of his daily ration. Even when reports of health problems after tobacco consumption emerged in the fifties of the 20th century, no social ostracism followed for decades.

The easiest way to see this is in film history - until the end of the 1980s, blue smoke permeated the screens. Smoking was a lifestyle. It is only in the last three decades or so that smoking has become the norm in most films: Characters, if they are allowed to smoke at all, are usually the villains. In contrast, alcohol is still a welcome "party guest", but has always been considered a morally dubious investment on the capital market.

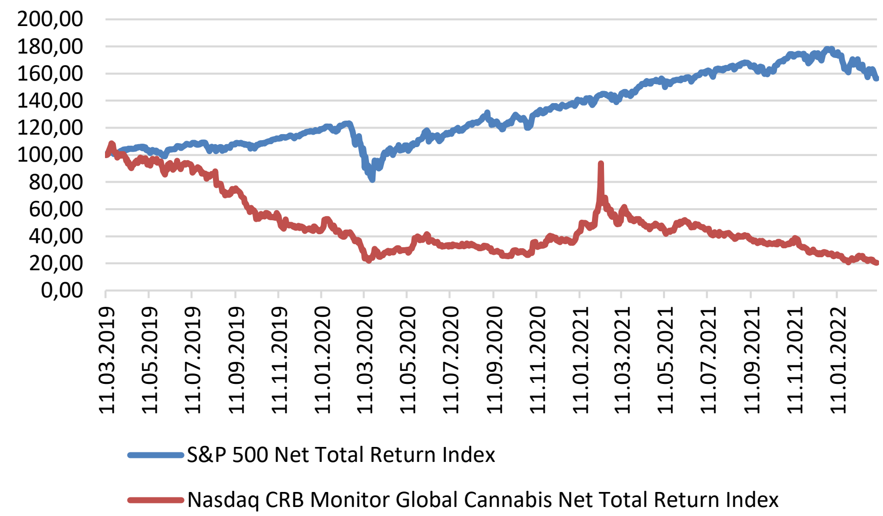
Sinful depending on your point of view

In any case, the gods of capital ban sometimes this, sometimes that from the portfolios, depending on the viewpoint: the Amana Growth Trust fund, which operates according to "Islamic principles", excludes alcohol, tobacco, pornography, weapons, gambling and fossil fuel producers, for example.

The Ave Maria Catholic Values Fund avoids healthcare companies that promote contraception or the use of embryonic stem cells. The fact that, for example, the view is blurred when it comes to alcohol was shown by the provider FaithStocks in funds that have since been wound up: a "Baptist" product did not even contain low-percentage alcohol, while a "Lutheran" portfolio only banned spirits. And a "Catholic" fund even endorsed alcohol.

Still rather frowned upon, but increasingly respected in parts of society due to its growing perception as a possible cure, is cannabis. In recent years, there have been numerous IPOs of young companies dealing in the hemp product, which have taken monetary advantage of this change from *sin stock* to *moral stock.* But a *buy and hold* after the initial public offering has so far regularly proved unhealthy for investor success (chart 4).

Chart 4: Cannabis Stock Index since inception and S&P 500



Source: Bloomberg, Flossbach von Storch Research Institute, as of March 2022. **Historical performance is not a reliable indicator of future performance.**

The arms industry also shows how difficult it is to draw boundaries within one of the sin industries. Anyone who manufactures firearms is pretty quickly frowned upon as a depot component; anyone who supplies military vehicles is not necessarily. And aren't computer chips built into every modern weapons system and doesn't the military work with software from well-known listed manufacturers and use their cloud services? In that case, investors would also have to banish hardware and software producers to the sin department - actually.

In any case, commodity companies that have something to do with oil and gas have fallen rapidly out of favour with the ethically correct. The synonym *black gold* alone speaks volumes about what oil once stood for: prosperity. The politically motivated shift towards renewable energies, which is now even being steered by the central banks, has now also branded oil stocks as *sin stocks*.

Explanation problems for institutional investors

Investing in *sin stocks* might just make private investors uncomfortable, it certainly makes institutional investors uncomfortable to explain: to their clients, to their boards or to government regulators. The effect: US asset managers reported $2.9 trillion in tobacco-related and $1.9 trillion in gun-related investment restrictions in 2018, according to data from the Global Sustainable Investment Alliance.

According to recent surveys by this group, a good 35 trillion dollars were "sustainably" invested at the beginning of 2020, which is said to have corresponded to an increase of 15 percent over two years. From a sober investor's point of view, all this would be a minor evil if stocks from the spurned sectors also performed poorly on the stock market in line with their image.

But this is far from the case - in fact, the opposite is true for one industry. A dollar invested in US tobacco companies in 1900 would have turned into a fortune of 6.28 million dollars over 115 years, including reinvestment of dividends, according to a study by Elroy Dimson, Paul Marsh and Mike Staunton of the London Business School.[3] The tobacco industry was the best performing industry on the US stock market from 1900 to 2015, averaging 14.6 per cent per year, according to the study. In the UK, the alcohol industry was at the top. Breweries and distilleries gave investors an increase in value from one pound sterling to a good 243,000 pounds in 1900 to 2015.

In contrast, Anglo-Saxon industries that were considered solid did much worse. Mechanical engineering firms, for example, only grew from one to 2,280 pounds within 115 years. US shipbuilders, also important as growth drivers, increased their value from one dollar to only 1,225 dollars in the same period.

Sin stocks also did exceptionally well in the near past. According to a study by Frank Fabozzi, a finance professor at Yale University, a broad portfolio of sin stocks yielded an annual return of about 19 per cent from 1970 to 2007, well more than double the market, which returned investors only 7.9 per cent per year. In 35 of the 37 years, *Sin Stocks* outperformed the general stock market, according to the study. From a $10,000 investment in sin stocks, investors would have found $6.3 million in portfolio value at the end of the study period, compared to only $164,000 in standard stocks.[4]

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[3] Elroy Dimson, Paul Marsh, Mike Staunton, Does it pay to be bad?, 2015
https://www.london.edu/think/does-it-pay-to-be-bad

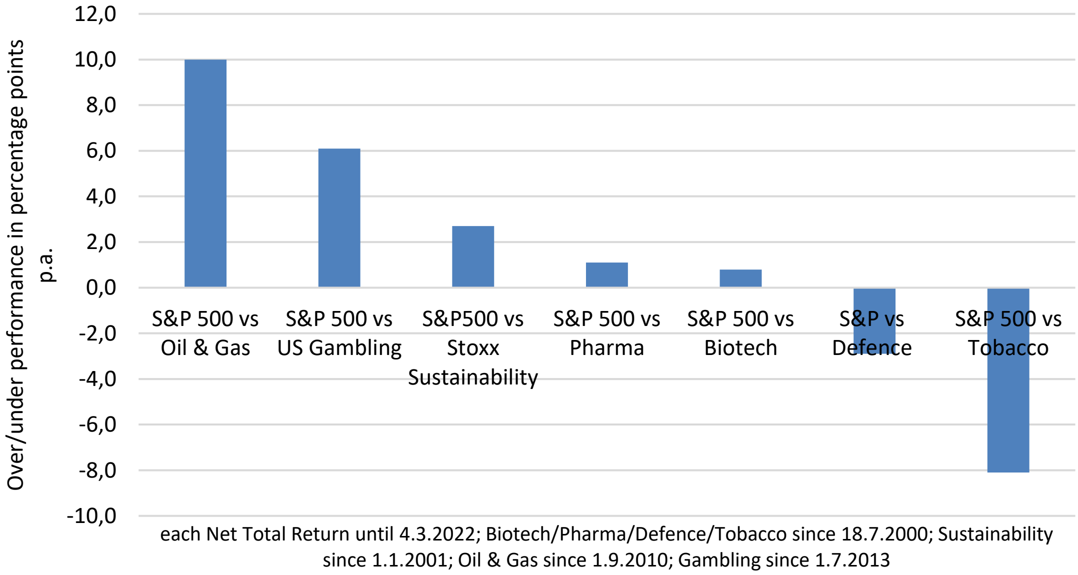
[4] Frank J. Fabozzi, K.C. Ma, and Becky J. Oliphant, Sin Stock Returns. The Journal of Portfolio Management, Fall 2008

Why is "sin" so profitable? In their 2008 study, Fabozzi et al. speculated that "sin companies" could achieve monopoly returns due to social ostracism and government regulation. However, in a later paper, Fabozzi and Blitz (2017) conclude that it is rather quality features of these companies in terms of profitability and investment that explain their outperformance.[5] One might think that "sin companies" are "quality companies". And isn't "quality" actually "sustainable"?

However, the buzzword sustainability has only really found its way into the world of the financial industry in this century. Does this now depress the performance of sin stocks compared to the overall market? The answer varies depending on the sector. Oil and gas as well as US gambling stocks, for example, perform relatively poorly compared to the overall market over almost twelve and almost nine years.

However, the same also applies to a broadly diversified investment with a sustainability label over a good 21-year observation period. Armaments and tobacco stocks have fared much better than the overall market since the beginning of this century. The S&P 500, for example, lags behind tobacco stocks by an enormous 8.1 percentage points per year (chart 5).

Chart 5: S&P 500 relative to sin indices

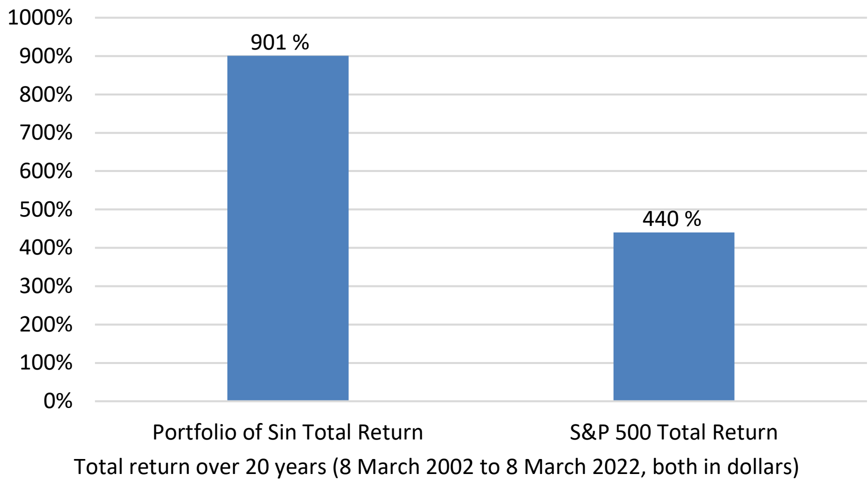


Source: Bloomberg, Flossbach von Storch Research Institute, as of March 2022. **Historical performance is not a reliable indicator of future performance.**

[5] David Blitz and Frank. J. Fabozzi. Sin Stocks Revisited: Resolving the Sin Stock Anomaly. Journal of Portfolio Management, Vol. 44, No. 1, 2017

However, sector indices often still reflect mass instead of class. This can also be seen in the performance of an equally weighted portfolio with the respective market leaders from the alcohol, oil, pharmaceutical, armament and tobacco sectors. Over a period of 20 years, investors achieved a total return of a good 900 percent with the "portfolio of sin" consisting of five stocks - which is more than double an investment in the S&P 500 (chart 6).

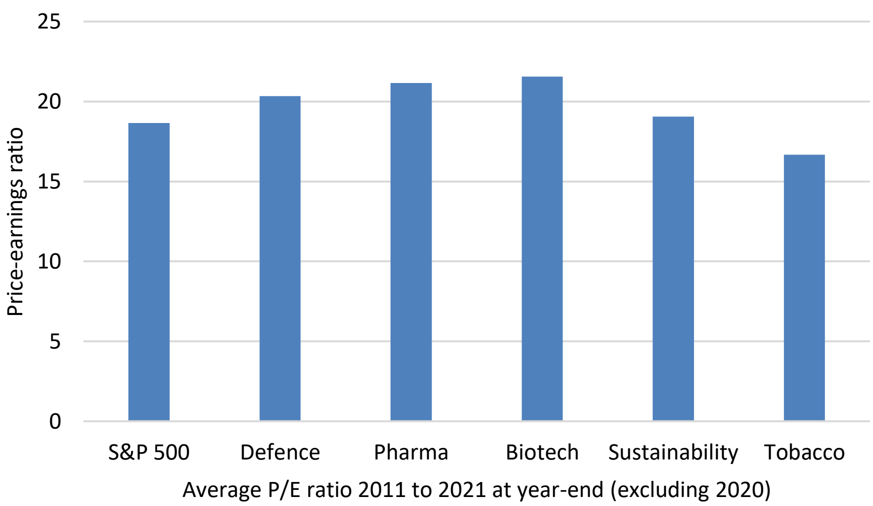
Chart 6: "Portfolio of Sin" and S&P 500



Source: Bloomberg, Flossbach von Storch Research Institute, as of March 2022. **Historical performance is not a reliable indicator of future performance.**

But what price did investors pay for this? Measured by the classic stock ratio, the price-earnings ratio (P/E), investors have recently given defence, pharmaceutical, biotech and "sustainable" stocks a higher valuation than the S&P 500 (chart 7, adjusted for the Corona year 2020 in each case).

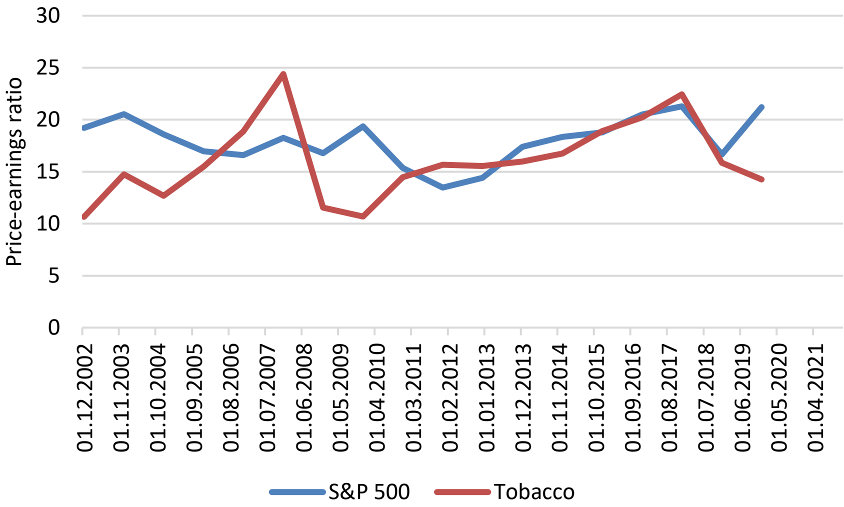
Chart 7: P/E ratio S&P 500 and P/E ratio sin indices, sustainability index



Source: Bloomberg, Flossbach von Storch Research Institute, as of March 2022

Investors regularly paid below-average P/E ratios for tobacco stocks. Most recently, the average P/E ratio of tobacco stocks compared to the P/E ratio of the S&P 500 was relatively lower than at any time in the past 20 years, except for the Corona year 2020 (chart 8).

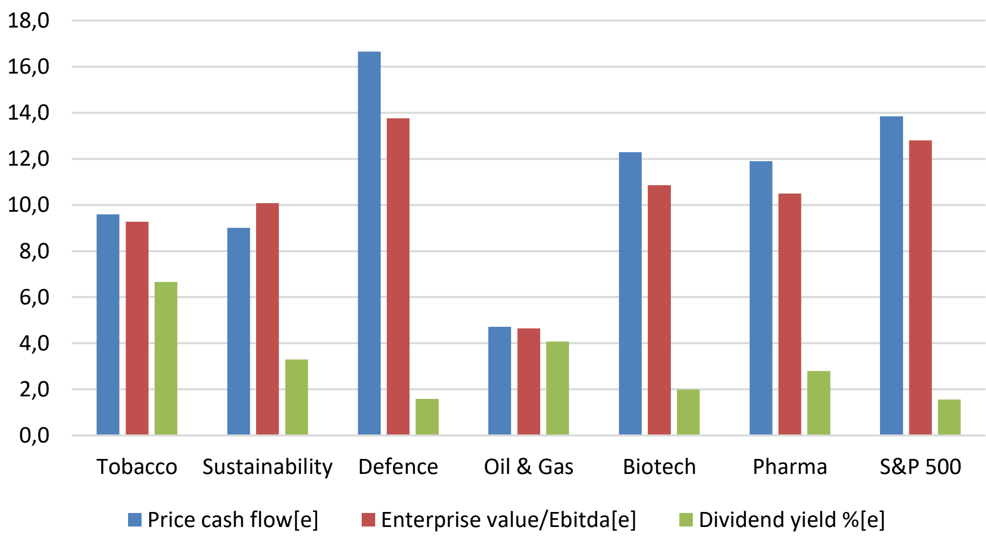
Chart 8: P/E ratio S&P 500 and P/E ratio tobacco index over 20 years



Source: Bloomberg, Flossbach von Storch Research Institute, as of March 2022.

Looking at expected cash inflows, enterprise value to operating earnings before asset write-downs and dividend yields also shows that (apart from the recently booming defence stocks) sin indices are currently valued lower than the S&P 500. This also applies to the STOXX Sustainability. The oil and gas sector has a particularly low valuation as measured by these three indicators (chart 9).

Chart 9: Evaluation of sin indices, sustainability index and S&P 500



Source: Bloomberg, Flossbach von Storch Research Institute, as of March 2022.

Conclusion

Measured by average annual returns, the broad market has outperformed some sin sectors such as oil, pharmaceuticals or gambling in recent years. But even investments that explicitly exclude *sin stocks* lag the market average.

Significantly better - both as "sustainable" investments and than the broad market - have been defence and tobacco stocks. A concentrated portfolio that also includes the leading alcohol producer (which regularly gets lost in mixed beverage and food indices) has also reaped significant excess returns. In terms of key valuation metrics, only the defence sector is currently valued higher than the broad market. Surprisingly, despite their significant outperformance, tobacco stocks are considered low valued, with expected dividend yields currently more than four times the market average as measured by the S&P 500.

For oil and gas stocks, common parameters signal a very low valuation. This could reflect a high degree of uncertainty about the efforts of these companies to develop their businesses away from fossil fuels ("*Beyond Petrol*"). However, this may (also) reflect a *margin of safety*; a buffer that could protect investors from larger losses due to low valuations of the securities. This requires a more in-depth analysis of the individual stocks.

Apart from oil and gas, most sin sectors are less affected by price-changing economic cycles, there is steady demand, which makes the papers fundamentally attractive - this could also explain the regularly higher P/E ratios compared to the overall market, apart from tobacco. Barriers to entry into the sin sector are also regularly high, which limits competition and can prevent potential margin erosion, especially in times of inflation.

Overall, it can be stated that the demarcation between a moral and an immoral investment is difficult and changes regularly over time. A good generation ago, for example, the chemical industry was considered uninvestable from a moral point of view because it polluted the environment. Today, for example, there are indications that the sugar processing industry is being targeted: a future additional taxation as with tobacco and alcohol is quite conceivable for sweet products in the foreseeable future.

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