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IN THIS ISSUE:

MIDTERM ELECTIONS—WHAT DO THEY MEAN FOR MARKETS? 1

THE GOOD AND BAD OF ESG INVESTING 2

MIDTERM ELECTIONS—WHAT DO THEY MEAN FOR MARKETS?

It's almost Election Day in the U.S. once again. For those who need a brief civics refresher, every two years the full U.S. House of Representatives and one-third of the Senate are up for re-election. While the outcomes of the elections are uncertain, one thing we can count on is that plenty of opinions and prognostications will be floated in the days to come. In financial circles, this will almost assuredly include any potential for perceived impact on markets. But should long-term investors focus on midterm elections?

Markets Work

We would caution investors against making short-term changes to a long-term plan to try to profit or avoid losses from changes in the political winds. For context, it is helpful to think of markets as a powerful information-processing machine. The combined impact of millions of investors placing billions of dollars' worth of trades each day results in market prices that incorporate the aggregate expectations of those investors. This makes outguessing market prices consistently very difficult.[1] While surprises can and do happen in elections, the surprises don't always lead to clear-cut outcomes for investors.

The 2016 presidential election serves as a recent example of this. There were a variety of opinions about how the election would impact markets, but many articles at the time posited that stocks would fall if Trump were elected.[2] The day following President Trump's win, however, the S&P 500 Index closed 1.1% higher. So even if an investor would have correctly predicted the election outcome (which was not apparent in pre-election polling), there is no guarantee that they would have predicted the correct directional move, especially given the narrative at the time.

But what about congressional elections? For the upcoming midterms, market strategists and news outlets are still likely to offer opinions on who will win and what impact it will have on markets. However, data for the stock market going back to 1926 shows that returns in months when midterm elections took place did not tend to be that different from returns in any other month.

In It for the Long Haul

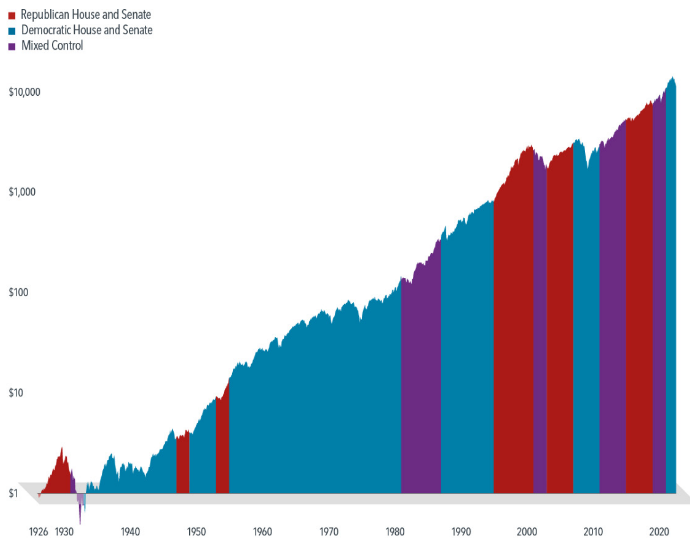
While it can be easy to get distracted by month-to-month or even one-year returns, what really matters for long-term investors is how their wealth grows over longer periods of time. Exhibit 1 shows the hypothetical growth of wealth for an investor who put $1 in the S&P 500 Index in January 1926. The chart lays out party control of Congress over time. We see that both parties have periods of significant growth and significant declines during their time of majority rule. However, there does not appear to be a pattern of stronger returns when any specific party is in control of Congress, or when there is mixed control for that matter. Markets have historically continued to provide returns over the

long run irrespective of (and perhaps for those who are tired of hearing political ads, even in spite of) which party is in power at any given time.

Exhibit 1.

Hypothetical Growth of $1 Invested in the S&P 500 Index and Party Control of Congress

January 1926–June 2022



Past performance is not a guarantee of future results. Indices are not available for direct investment; therefore, their performance does not reflect the expenses associated with the management of an actual portfolio.

Equity markets can help investors grow their assets, and we believe investing is a long-term endeavor. Trying to make investment decisions based on the outcome of elections is unlikely to result in reliable excess returns for investors. At best, any positive outcome based on such a strategy will likely be the result of random luck. At worst, it can lead to costly mistakes. Accordingly, there is a strong case for investors to rely on patience and portfolio structure, rather than trying to outguess the market, to pursue investment returns.

—From Dimensional Fund Advisors
Sep 16, 2022

[1] This is known as the efficient market theory, which postulates that market prices reflect the knowledge and expectations of all investors and that any new development is instantaneously priced into a security.

[2] Examples include: "A Trump win would sink stocks. What about Clinton?" CNN Money, 10/4/16, "What do financial markets think of the 2016 election?" Brookings Institution, 10/21/16, "What Happens to the Markets if Donald Trump Wins?" New York Times, 10/31/16.

THE GOOD AND BAD OF ESG INVESTING

At first, it seemed like everyone wanted to jump on the ESG train. Then they wanted to jump off. If you're confused over the about-face, read on. This article gives the good and bad of ESG investing so you can decide whether it's for you.

ESG—What Is It Good for?

No, the answer isn't "Absolutely nothing (say it again)." Criticism aside (we'll get to that shortly), ESG funds and ETFs can help investors align their portfolios with their values.

ESG stands for **e**nvironmental, **s**ocial, and **g**overnance. Most people understand the practice to mean rating companies on how well they live up to ESG standards. For example, do they promote workplace diversity? Are they implementing carbon-neutral policies?

Done well, we believe that ESG and other values-based investment processes like socially responsible investing (SRI) can help lead to change for the better in corporations and the world.

In addition, a portfolio that reflects an investor's values can help keep them invested when markets get volatile. Consider this quote from *Forbes*[1]:

> *"There is a consensus that investors who can form some sort of attachment to their funds tend to stick with them when things get a little turbulent in the markets, Overall, that's probably a good thing for most long-term investors who need to have a buy and hold strategy. That's a very valuable behavioral component that ESG investing brings to the table."*

So if an ESG-based portfolio can help you invest your values and reach your goals, what's the problem?

Well, there are a few concerns …

The Downsides of ESG

Here are a few key issues you need to know before diving into ESG.

1. Companies can get a passing grade even when you disagree with their policies. ESG investments ideally encourage companies to do better. But portfolios can still contain corporations that you think fall short.

You may find yourself invested in a technology company that is creating waste cesspools from rare earth mining. Or take this example from a *Bloomberg* article on ESG ratings.[2] It reports that McDonald's had 54 million tons of emissions in 2019—an *increase* of about 7% in four years. Yet that same year, ratings company MSCI gave McDonald's an upgraded score for its environmental impact.

"Why?" the article asks. "Because MSCI determined that climate change neither poses a risk nor offers 'opportunities' to the company's bottom line."

This leads us to our second point:

2. Ratings are not standardized. You may think ESG scores are based on how well the company benefits the world. But they may be based on how well the policies boost the company's profits.

Some would say the distinction doesn't matter. What benefits the company benefits the world—and that can be true. But did the McDonald's emissions help us globally? Every individual must come to their own answers to such questions.

Scores can vary widely based on the company providing them. Says the same *Bloomberg* article referenced above:

> *"Each ESG rating provider uses its own proprietary system, algorithms, metrics, definitions, and sources of nonfinancial information, most of which aren't transparent and rely heavily on self-reporting by the companies they rate. No regulator examines the methodology or the results."*

YOU AND A GUEST ARE INVITED:

RETIREMENT 2023 AND BEYOND: WHAT YOU NEED TO KNOW TO MAKE IT SUCCESSFUL

This retirement presentation and dinner would be a great way to introduce a friend or relative to our firm.

Our advisory team will share steps to help create a successful retirement.

Topics we will cover include:

- How to make smart decisions with your money
- How to enhance your wealth through smart tax strategies
- How and when to transfer your wealth
- How to protect what you have built
- How to use charitable planning to your advantage

Please RSVP by November 4, 2022

This is an intimate event with limited attendance, so please make sure to reserve your spot. Please RSVP to Charles Thomas at **Charles@northstarplanners.com.** We look forward to seeing you on November 14!

THE DETAILS

Monday, November 14, 2022
6 p.m. (dinner will be served)

RENAISSANCE FORT LAUDERDALE WEST HOTEL

1230 S. Pine Island Road, Plantation, FL 33324

WHO WE ARE

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STEVE TEPPER, CFP®, MBA
Vice President, Chief Operations Officer, Chief Compliance Officer, Senior Financial Advisor

GARY S. GLANZ
Director of Business Development, Investment Advisor Representative

FELIPE MEJIA, CFP®
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CHARLES THOMAS, MBA
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3. Fees can be higher, and diversification can be less. Since ESG funds aren't tracking an index, they're not taking a passive approach. It requires research to decide which companies get included and which get cut. This can lead to higher fees.

ESG can also lead to less diversification. Many ESG funds have tanked in 2022 for the same reason they did great before: They are often knee-deep in technology companies, which had a stellar run until they took a hit this year.

Having a properly diversified portfolio (or owning a little bit of everything) can help insulate investors from short-term market swings while they work toward their long-term goals.

So Do You Invest or Not?

If this article proves anything, it demonstrates the importance of researching before investing.

Follow MarketWatch's advice[3] and make sure to read the fund or EFT prospectus and disclosure materials to see whether the definition of ESG is *your* definition. Compare fees, understand diversification (or lack of), and read annual reports.

Finally, understand what you're willing to sacrifice vs. what you stand firm on. Do you refuse to have certain highly profitable companies in your portfolio? Do you accept that their exclusion may mean you earn fewer returns than, say, a portfolio tracking the S&P?

The allure of ESG is that it promises to make values and money compatible when they are so often held in opposition. Don't hesitate to talk with us to find the right balance for you.

This material was prepared by Kaleido Inc. from information derived from sources believed to be accurate. This information should not be construed as investment, tax or legal advice.

[1] Kate Ashford, "Pros and Cons of ESG Funds," *Forbes*, 10 April 2019, https://www.forbes.com/advisor/investing/pros-and-cons-of-esg-funds/.

[2] Cam Simpson et al., "The ESG Mirage," *Bloomberg*, 9 December 2021, https://www.bloomberg.com/graphics/2021-what-is-esg-investing-msci-ratings-focus-on-corporate-bottom-line/.

[3] Richard Eisenberg, "Putting Your Money Where Your Values Are: A Guide to Socially Responsible Investing," MarketWatch reposted on MSN.com, 17 August 2022, https://www.msn.com/en-us/money/other/putting-your-money-where-your-values-are-a-guide-to-socially-responsible-investing/ar-AA10KdJc.

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