Toward Better Philanthropy
Consistency of Mission and Investment

By Jon Quigley, CFA

phi-lan-thro-py (noun)
1. desire to benefit humanity; desire to improve the material, social, and spiritual welfare of humanity, especially through charitable activities.

Individual philanthropists, endowments, and foundations alike serve a critical role in a capitalist society. America’s earliest and greatest titans of industry—John D. Rockefeller and Andrew Carnegie—defined the structure of modern philanthropy. Rockefeller used his considerable petroleum fortune to target causes in medicine, education, and scientific research. Carnegie used his steel fortune to fund libraries, education, and scientific research, and to promote world peace.

Today, the Bill and Melinda Gates Foundation is the philanthropic vehicle for two U.S. titans of industry (Gates and Warren Buffett), and it supports a plethora of causes including housing, the arts, land conservation, human rights, and the impact of technology.

These individuals and groups invest their personal fortunes along with generous gifts from donors over many, many years. To sustain the donations, endowed funds typically are invested in a portfolio of marketable securities with the growth portion invested in equities. To avoid investing in industries that may present a conflict of interest, investment funds of many mission- or faith-based organizations are prohibited from owning stocks of alcohol, tobacco, or gaming companies.

To improve upon this approach, investors can use a set of rich extra-financial information known as environmental, social, and governance (ESG) ratings. Potential investments can be judged by their financial statements as well as their environmental policies and footprints, their governance structures, and their relationships with their workers and their communities. Below, we present the case that incorporating ESG ratings in the portfolio construction process substantially improves social return on investment for mission- and faith-based organizations and also helps control portfolio risk.

Measuring the Impact of the Endowment Portfolio

How do we rigorously and accurately measure the impact of a philanthropic dollar? The impact per dollar is known as the social return on investment or SROI (http://thesroinetwork.org). Effective measurement of SROI can help build a feedback loop that allows increased impact per dollar of giving.

When the size of the endowment portfolio and the SROI of the grant remain constant, the investment return may be the only remaining impact lever. It’s no surprise then that many philanthropies seek to maximize return of their investment portfolios (while maintaining enough short-term liquidity to fulfill near-term giving).

In this case, beta, market portfolio, and portfolio alpha are the levers for improving investment return.

Tradeoff: Pre-Grant Impact vs. Investment Return

The benefit of an investment portfolio often is viewed solely as the number and size of the grants it enables. This is indeed a key benefit of a philanthropy’s portfolio, but it’s not the only benefit. There’s also the impact that the invested money can have before it is disbursed.

About 5 percent of endowments and foundations target a portion of investment dollars toward mission-related investments, i.e., investments that are consistent with and/or advance a cause. These may include below-market-rate investments where the expected rate of return may be near zero. An example would be funding low-interest business loans that have a substantial risk of default in a low-income neighborhood. The opportunity cost for this type of investment is offset by the positive societal impact of the investment.

Total impact of market-rate investments is calculated the same way. As the name implies, the expected investment return on this portfolio is expected to be substantially higher than that of a below-market-rate portfolio. In this scenario, however, there is a negative pre-grant SROI on the endowed portfolio while invested if the endowed portfolio is invested in alcohol, tobacco, and gaming companies and the negative externalities associated with their products.

Balancing Social Return and Investment Return

Most all religious endowments use some form of socially responsible investing (SRI), which is rooted in religious beliefs. Religious endowments have long screened their investments from...
Wide-scale incorporation of ESG considerations eventually will cause companies with poor operating practices to face substantially higher capital costs, and the best operators should see reduced capital costs.

Companies that deal with tobacco, alcohol, abortion, gaming, or the military. Secular endowments and foundations may have social screens of their own; shunning tobacco stocks is commonplace. Others won’t own stock of military and defense companies, or companies that derive revenue from regions or countries that present a conflict of social interest, such as the Sudan. This screening curbs the negative pre-grant SROI of the endowed portfolio. However, social screening has given rise to a fear that it may result in lower investment returns and ultimately reduced giving.

Recent research shows, however, that eliminating investments in companies that derive more than 5 percent of revenue from alcohol, gaming, tobacco, military and defense, or the Sudan (as measured by KLD Research & Analytics) limits the large-cap investment universe by 5–7 percent (Quigley and Taylor 2010) and has minimal impact on expected total return (Quigley 2009). The majority of active equity strategies employ some type of investment screen (e.g., not buying stocks at above-average valuation multiples), and often these screens are far more restrictive social screens (though managers that use such screens would argue they simply are eliminating candidates they deem likely to underperform).

A More Powerful Impact Solution: ESG Integration

Social screens still are relevant for certain philanthropic and religious portfolios, but they are taking a backseat to ESG, a rapidly improving field of research and information for investors and philanthropic groups looking to maximize total impact.

A philanthropy’s market-rate investment portfolio may incorporate ESG information to better align investments and mission—and grapple with issues such as the following:

- Does an endowment focused on land conservation invest in companies that pollute or waste resources, directly or indirectly lowering the cost of capital for such firms?
- Should a philanthropist targeting medicine and health care invest in companies that provide little or no health care support or have a high rate of employee injury or death?
- Does a poverty-focused philanthropic group invest in companies with heavily skewed compensation structures?
- Should a philanthropist supporting minority causes invest in companies with nondiverse boards or human-rights controversies?

Including such considerations curbs the negative impact of the investment portfolio and also creates positive impact by altering capital costs for a broad swath of public companies. Wide-scale incorporation of ESG considerations eventually will cause companies with poor operating practices to face substantially higher capital costs, and the best operators should see reduced capital costs. In fact, a portfolio tilted toward companies with the best ESG practices significantly increases the SROI of the endowed portfolio by altering the cost of capital for firms.

Risk Benefits of ESG Integration

Incorporating ESG information provides substantial risk benefit. Anecdotally, it’s easy to understand why investments in companies with poor ESG practices are more risky:

- A company with poor environmental practices may face substantially higher capital expenditures as regulators tighten emission standards; in the event of an environmental accident, such a company will face substantial containment, clean-up, and reparation costs.
- A company employing child labor or placing its workforce in high-risk environments, whether directly or in the supply chain, faces a substantial risk of consumer boycott and subsequent revenue loss.
- A company with a poor governance structure may be more susceptible to untoward or downright fraudulent activity.

In each of these instances, the companies may be burdened by future litigation costs.

The risk story isn’t solely anecdotal, however. Research has shown that companies that rank poorly along ESG lines demonstrate substantially higher return volatility (Quigley 2010) and that return volatility is heavily skewed (Quigley and Taylor 2010). Companies that have poor ESG ratings are more likely to experience extreme negative outcomes (Quigley and Taylor 2010).

Return Impact of ESG Integration

Can incorporating ESG information into stock analysis and portfolio construction negatively impact returns? A review of 20 academic studies revealed only three that show a negative relationship between ESG factors and portfolio performance (UNEPFI and Mercer 2007). The same study reviews...
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10 brokerage reports and concludes that none show a negative relationship between ESG factors and portfolio performance. Further evidence that SRI assets have an increasing and significant impact on stock returns is contained in Becchetti et al. 2007, and Watson Wyatt and Russell also have issued supportive studies (Goodland 2007; Collie and Myers 2008).

Ultimately the fully integrated ESG portfolio has a better pre-grant impact and an impact of investment on grant that is equal to or better than that of a market-rate portfolio. It’s also better than a market-rate portfolio when volatility and tail risk of the investments are considered.

Conclusion
Investment advisors and consultants need to build deep understandings of the missions of their philanthropic clients. The optimal ESG-integrated portfolio can and should accentuate the specific interests of the philanthropist. While preferable to a portfolio that disregards ESG issues, a one-size-fits-all approach to ESG incorporation will fall short. Failure to include ESG information results in a less-comprehensive analysis at the security level, a suboptimal investment portfolio, and less-than-maximum impact for a philanthropist’s mission.

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References

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