Are Your Investments Aligned with Your Organization's Mission and Values?

By Norman Nabhan, CIMA®

Many believe that impact and sustainable investing is a niche in the investment industry reserved for religious, environmental, and social impact foundations. There is also a perception that "impact investing" involves sacrificing investment returns to "do good" and become a "socially conscious" investor. The fact is that neither of those presumptions is true and that impact investing is rapidly going mainstream.

According to the Forum for Sustainable and Responsible Investment (US SIF) 2016 survey in the United States, sustainable and impact investing continues to gain traction with total assets at the beginning of 2016 at $8.7 trillion, up 33 percent from $6.6 trillion in 2014, across strategies employing different approaches such as negative screening, environmental, social, and governance (ESG) integration, and corporate engagement or shareholder action. The vast majority of these assets are held by institutions; however, there is a growing demand by individual investors in this space.[1] A recent survey by Morgan Stanley's Institute for Responsible Investing found that 84 percent of millennials are interested in socially responsible investing. At a macro level, institutional asset managers are increasingly integrating ESG considerations into their core investment disciplines and processes even if they do not consider themselves to be "impact managers." At a micro level, very specific investment products are being created for investor access to these themes. As of 2016 there were $3.3 billion in assets in newly created exchange-traded funds (ETFs) focused on the environment. In addition, investors are now more actively engaging in investor advocacy by engaging with corporate management on ESG issues. From 2014 to 2016, 176 institutional investors and 49 money managers filed shareholder resolutions on ESG issues. In addition, 57 institutional asset owners reported that they engaged in dialog with companies on ESG issues, as did 61 money managers.[2]

To properly explore impact investing it is important to understand that this is not a new thing or a Wall Street fad. The history goes back quite a way. In 1898, the Quaker Friends Fiduciary Corporation was founded and it adopted a policy of making no investments in weapons manufacturers, alcohol, or tobacco companies, a position that was consistent with the beliefs and values of the Quakers. The number of adopters of such policies that are consistent with their faith or values has evolved and compounded over the years. According to the Morgan Stanley Institute for Sustainable Investing, today one of every six dollars invested in the United States has some type of mission alignment.[3] That alignment may be with faith-based values such as birth control or alcohol use, but as of late it may be less exclusionary and more proactive, in search of investments that have a positive impact on any number of values such as climate change, corporate governance, or social concerns such as diversity or sustainability.

As for the commonly accepted idea that to embrace a socially conscious or impact investing strategy you must give up investment returns, today there is ample evidence that is not necessarily the case either.

Let's explore these assumptions in greater detail and look at both the evolution of impact investing and the increasing numbers of investment options that can provide highly competitive returns.

THE EVOLUTION OF IMPACT INVESTING

In 1977, the first socially responsible investment fund was founded that sought to invest in companies with attributes that would contribute to positive social change. That same year, largely led by Catholic women's organizations, the Sullivan Principles of Action and Divestment were announced to curtail investments in South Africa in an attempt to influence the government to end apartheid. This was a long and protracted effort, and the embargo on investments in South Africa is credited with helping to bring an end to the policy.

In the 1970s and 1980s, it was common to see investment policy statements for religious or healthcare organizations that would specifically exclude certain investments that were not consistent with their missions such as investments in alcohol or tobacco manufacturers or drug companies producing birth control devices. Investment policy statements were written to specifically prohibit asset managers from making those investments, and consulting firms developed technology to prevent those types of purchases and to monitor compliance with investment policy. Today, in my experience, it is far more common to see investment policy statements drafted to attempt to align an organization's investments with its mission and values.

We are now seeing fixed income managers that will invest in "green bonds" that finance schools and playgrounds in certain communities or mortgage-backed bonds that provide mortgages for low- and middle-income housing and allow investors to target which bonds will go into their portfolios. A community foundation, healthcare foundation, or any other social impact foundation may want some of its fixed income portfolio to provide mortgages specifically in local low- and middle-income housing projects, healthcare facilities, or schools or parks. If having an impact in the local community is part of the mission statement, then having local investments aligned with that mission makes sense. Most foundations make grants each year of 4–5 percent of portfolio value with an eye toward having an impact on carrying out their specific missions. There is a growing sense that using the larger 95 percent of the portfolio to create impact can also be consistent with further driving the mission. Being able to steer those fixed income investments into their own communities is a way to utilize a larger percentage of portfolios to further mission-related success.

Although negative screening has been with us for many years, we are now seeing well-established asset management firms develop faith-based portfolios specifically invested in alignment with Catholic, Baptist, or other specific religious values. In examining the Informa Database of investment manager returns, we see the emergence of equity asset managers with solid and competitive track records that invest in companies they believe will have superior returns because they have strong ESG characteristics. Many asset management firms that screen for strong ESG characteristics have begun to go further. Many have become activist investors filing shareholder resolutions to promote stronger values toward sustainability, diversity in the workforce and on governing boards, and other social issues. This activity often forces corporate boards and senior management to have an active debate on these issues before they become controversial issues at shareholder meetings. In many cases, managers and board leadership have opted to make the requested changes before they go to a shareholder vote. The growing interest by investors in finding companies that have strong ESG guidance is allowing institutional investors to set the bar higher on diversity, sustainability, and corporate governance.

This is definitely not a new trend, but it has clearly gained significant traction in the past decade. Women and millennials are twice as likely to embrace some type of impact investing solution.[4] In the past several years, I have rarely attended a foundation conference where the impact investing sessions didn't draw a packed house.

Like most things, as a trend develops and interest builds, more solution providers come to the fore to meet demand. Today a large number of highly experienced firms with strong investment methodology and long track records are providing impact investment solutions. The 2016 US SIF report stated that there were 925 distinct asset management funds representing $7.79 trillion in assets that incorporated ESG criteria into their stock or bond selection process.[5] In addition to many asset management firms with specific ESG-focused or values-alignment portfolios, we are also seeing a proliferation of investment vehicles such as ETFs that target very specific strategies such as low carbon investments, global water supplies, gender diversity, and environmental issues such as energy, clean water, waste treatment, recycling, and sustainable food supplies. For example, Philippe Cousteau, Jr., grandson of famous diver Jacques Cousteau, has created an ETF that invests in efficient energy, women's and children's issues, and renewable energy. In a unique twist to impact investing, a part of the management fee goes to the Earth Echo Foundation, his charity that is devoted to ocean conservation and restoration.

There is plenty of evidence to show that ESG can enhance investment performance. A 2014 report by the University of Oxford and Arabesque Partners ("From Stockholder to Stakeholder: How Sustainability Can Drive Financial Outperformance," September 2014) analyzed more than 190 academic studies and sources on sustainability to assess how sustainable corporate practices can affect investment returns. It concluded that "88% of the research shows that solid ESG practices result in better operational performance of firms and 80% of the studies show that stock price performance of companies is positively influenced by good sustainability practices."

In 1990, the Domini Social Index was created (now the MSCI KLD 400 Social Index Index) to serve as a measurement benchmark for socially responsible investing. The MSCI KLD 400 Social Index is a capitalization weighted index of 400 U.S. securities with exposure to companies with outstanding ESG ratings and excludes companies whose products have negative social or environmental impacts. Since 1990, the KLD 400 Social Index has outperformed the S&P 500 Index. According to Morgan Stanley's Institute for Sustainable Investing, the KLD 400 Social Index had a return from 1990 to the end of 2014 of 10.14 percent versus the S&P 500 over the same time frame of 9.69 percent.[6] It may make sense that companies that are paying attention to diversity, sustainability, and the impact they have on the environment through safety, training, recycling, and "best practices" should have less risk of destabilizing events that could cause "headline risk." Environmentally friendly practices at corporations have been discussed for a long time. Researchers now say with a high degree of confidence that eco-efficiency relates positively to operating performance and market value, adding that "although environmental leaders may not sell at a premium relative to laggards, the valuation differential increased significantly over time."[7] We are seeing companies take this to heart; for example, makers of consumer products concerned about limited water resources and the role that products may play educate customers on the issue and employ technology in manufacturing to better manage water use. This has been supported by some studies that have shown that companies with high ratings for ESG have lower costs of capital and lower risk of default.[8] This can lead to an improvement in the risk/reward characteristics of a portfolio.

INVESTMENT OPTIONS

A number of alternative investment opportunities have begun to focus on impact and ESG criteria in guiding their investment strategies to round out institutional asset allocation strategies. Hedge funds and private equity funds are providing access to investors to provide returns with a lower correlation to the equity markets and to also have a positive impact on their targeted investment areas such as job creation, food production, and distribution and education in the emerging markets. Both the asset managers and the consultants that track them are developing impact reports that report financial returns to investors as well as the impacts the investments have had in the targeted communities. Of course, alternative investments and private equity interests may be highly illiquid, involve a high degree of risk, and be subject to transfer restrictions. These would be additional considerations for investors to consider.

"Vision 2050: The New Agenda for Business" published by the World Business Council for Sustainable Development estimates that the business opportunities for sustainability-focused companies are expected to be between $3 trillion and $10 trillion annually, or up to 4.5 percent of global gross domestic product.[9] Companies are improving their competitive positions and returns by adjusting their business strategies to address long-term global themes and mega-trends including climate change, water quality, waste management, food availability, health and wellness, improving lives, and aging populations.[10] Clearly, asset management firms that can identify strong companies that are well-positioned to solve these societal problems may have the potential to deliver excellent returns.

An often-asked question at impact investing presentations comes from trustees and board members who are concerned that they may be breaching their fiduciary duties by focusing on impact investing and not the achievement of the highest returns. There is now ample evidence that investors may not be giving up returns, but to further give them comfort, the Department of Labor has weighed in on the debate.

In an announcement, former U.S. Secretary of Labor Tom Perez clarified the Department of Labor view that "Environmental, Social and Governance (ESG) factors may be considered relevant to evaluating an investment's economic merits." Perez stated:

> *Investing in the best interests of a retirement plan and in the growth of a community can go hand in hand. We have heard from stakeholders that a 2008 department interpretation has unduly discouraged plan fiduciaries from considering economically targeted investments. Changes in the financial markets since that time, particularly improved metrics and tools allowing for better analysis of investments, make this the right time for us to clarify our position …*
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> *The new guidance, Interpretive Bulletin 2015-01, confirms the department's longstanding view from IB 94-1 that fiduciaries may not accept lower expected returns or take on greater risks in order to secure collateral benefits, but may take such benefits into account as "tiebreakers" when investments are otherwise equal with respect to their economic and financial characteristics. The guidance also acknowledges that environmental, social, and governance factors may have a direct relationship to the economic and financial value of an investment. When they do, these factors are more than just tiebreakers, but rather are proper components of the fiduciary's analysis of the economic and financial merits of competing investment choices.*

Foundations and nonprofits are not subject to the Employee Retirement Income Security Act (ERISA), but many of the court cases about nonprofit fiduciaries have pointed to the tenets of ERISA for guidance.

CONCLUSION

Investing with impact has evolved and will continue to develop in the future, and it is rapidly moving into the mainstream. Leading competitive strategy guru Michael Porter, creator of "Five Competitive Forces," stated that he has begun to see a link between ESG integration and business success. In the paper "Measuring Shared Value," Michael Porter et al. estimates that in excess of 3,500 organizations in more than 60 countries use the Global Reporting Initiative (GRI) sustainability standards to report on ESG performance.[11]

As continued evidence builds that returns are competitive and as top-tier investment management firms move into the space, the choices will become easier for trustees and investment committees. If asset managers are successful in identifying companies that are solving the problems of the future, their returns should be highly competitive.

In my experience, we are seeing more boards specifying that, given equal track records and past performance, they will opt for asset management firms with investment styles that align with their organizational goals.

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ENDNOTES

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