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From SRI to ESG: The Changing World of Responsible Investing

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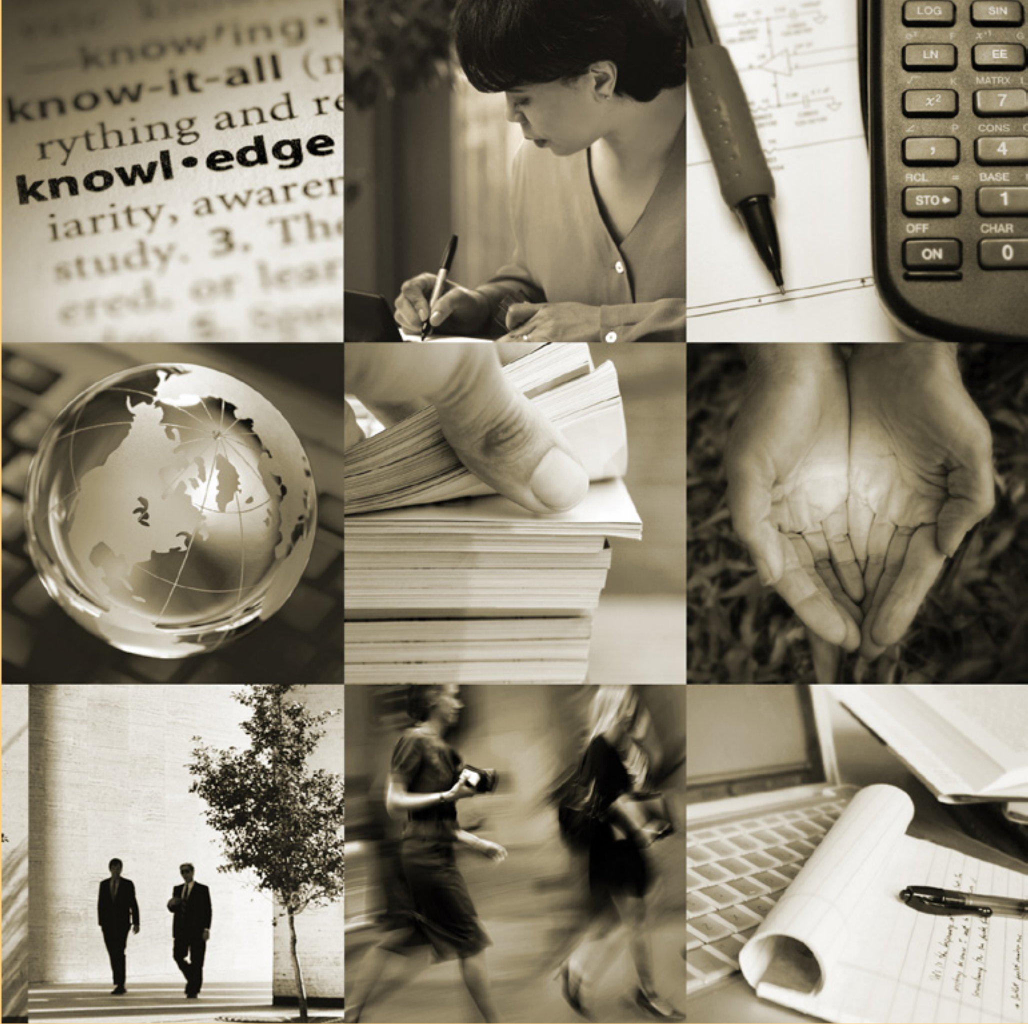

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Commonfund Institute is dedicated to the advancement of institutional investment knowledge and the promotion of best practices in financial management. Together with NACUBO, Commonfund Institute produces the annual NACUBO/ Commonfund Study of Endowments (NCSE™). Additionally, Commonfund Institute produces a wide variety of resources, including conferences, seminars, white papers and Regional Trustee Roundtables. The Higher Education Price Index (HEPI) issued annually, is viewed as a vital planning index by financial treasurers. In its 20th year, Commonfund's annual Endowment Institute is held at the Yale School of Management, and also convenes sessions in Asia and England. To learn more, please visit Commonfund Institute Corner at www.commonfund.org.

From SRI to ESG: The Changing World of Responsible Investing

Thoughtful investment professionals continue to debate whether a portfolio's long-term performance can be enhanced by including environmental, social and governance (ESG) considerations in the security selection process, but responsible investing is more than a passing trend. Long-term fiduciaries should educate themselves on the fundamental arguments for and against ESG, and think critically about its meaning for the institutions they serve.

Introduction

The terms socially-responsible investing, mission-related investing, impact investing and environmental, social and governance investing – all frequently grouped under the heading of responsible investing – have become a familiar part of the vocabulary of institutional and retail investors. Just what these terms mean in practice, however, and how their practitioners' claims can be impartially assessed, has been less clear. The goal of this paper is to provide a road map to the responsible investing landscape for governing boards and committees who are considering whether and how to integrate environmental, social and governance factors into their investment process. We begin with a review of the principal categories of responsible investing, and assess the way in which the world of responsible investing has moved from a practice of negative screening and exclusion of certain types of investment to one of seeking or encouraging certain characteristics in portfolio companies. We provide estimates of the size and growth trajectory of the responsible investing market, and describe some of the institutional forces that are driving these trends. Finally, we suggest some policy approaches that interested institutions might take and supply a series of references for readers seeking further information about this rapidly-evolving field.

Part I
Responsible Investing: Terminology and Background

There are three main categories of responsible investing:

- Socially-responsible investing (SRI), a portfolio construction process that attempts to avoid investments in certain stocks or industries through negative screening according to defined ethical guidelines;
- Impact investing, which involves investing in projects or companies with the express goal of effecting mission-related social or environmental change; and
- Environmental, social and governance (ESG) investing, which involves integrating ESG factors into fundamental investment analysis to the extent that they are material to investment performance.

These investment approaches serve very different purposes. SRI and impact investing use funding and investment activities to express institutional values or advance the institution's mission. In contrast, ESG investing aims to improve investment performance, thereby making additional resources available for

mission support.

SRI was for a long time the most widely-used of the three approaches. In recent years, however, it has been argued that, although negative screening can be a useful tool for institutions desiring to express ethical, religious or moral values through their investment portfolio, for many it may prove too restrictive. ESG analysis takes a broader view, examining whether environmental, social and governance issues may be material to a company's performance, and therefore to the investment performance of a long-term portfolio. Thus, while not every institution will choose to engage in SRI or impact investing, fiduciaries of long-term institutional investors should seek to develop a well-reasoned view on their institution's approach to ESG investing.

Current State and Evolution of Responsible Investing

Assets invested using responsible investing practices are substantial and growing. According to a recent report,[1] the responsible investing market in the U.S. was estimated at year-end 2012 to have $3.74 trillion in assets under management, representing 11.2 percent of the $33.3 trillion total assets under management in the U.S.[2] From 2010 to 2012, assets managed under sustainable and responsible investing principles grew by approximately 22 percent from the $3.07 trillion reported in 2010. Of the $3.74 trillion total, $3.31 trillion were held by 443 institutional investors, 272 money managers and more than 1,000 community investment institutions that select or analyze their portfolios using various ESG criteria. In addition, $1.54 trillion in assets were held by more than 200 institutional investors or money managers that filed or co-filed shareholder resolutions on ESG issues at publicly traded companies from 2010 through 2012.[3]

The roots of responsible investing go back to the colonial era in the U.S., when some religious groups refused to invest their endowment funds in the slave trade. But it was not until the 20th century that SRI began to take form as a specific investment philosophy. In 1921, the Pioneer Group became the first mutual fund to screen out tobacco, alcohol and gambling investments. In the 1960s, SRI found a voice in the civil rights, environmental, social and anti-war protest movements.

In the 1970s, environmental awareness continued to grow, and the first funds to focus on issues beyond the traditional "sin" screens were introduced. The struggle against apartheid in South Africa led to the creation of the first funds that screened out companies doing business in a given country, igniting a still-unresolved debate as to whether exclusionary investing helps a country by speeding the demise of unjust institutions or harms it by causing companies to leave, thereby slowing economic growth and, potentially, hampering the pace of reform.

By the mid-1990s there were nearly 60 SRI mutual funds, and SRI assets under management totaled about $640 billion.[4] In the 21st century climate change, corporate scandals and humanitarian crises have arisen as new concerns.

In recent years, SRI has become increasingly associated with the practice of barring or restricting investment in certain companies or industries based on ethical beliefs. Because this approach limits the range of securities available for investment, it has been argued that it can lead to lower investment performance and is thus incompatible with an institution's fiduciary duty to maximize return on investment. Other voices, however, have noted that investors frequently choose to limit their investment universes by favoring certain asset classes, industries or companies, and that this process is a fundamental part of investment practice. In any case, partly as a result of this perception of restriction, SRI has become unpalatable for many institutions where specific guidelines do not exist that require strict screening of investments.

There is also, however, a growing recognition that certain environmental, social and governance issues not captured by traditional investment analysis can prove material to investment performance. Studies identify issues such as energy efficiency, carbon emissions, toxic waste treatment, workplace safety, employee relations and corporate governance as materially affecting traditional financial indicators such as price/earnings ratio and reputation with investors. These studies, which we discuss more fully elsewhere in this paper, form the theoretical basis for ESG investing as it is evolving today.

The link between ESG factors and investment performance was formalized by the United Nations in 2006 when it promulgated the Principles for Responsible Investment (PRI), a set of practice standards offered for voluntary adoption by investors. Rather than precluding investment in companies having poor environmental, social or governance records, PRI asks that investors take ESG factors into consideration to the

1 US SIF Foundation, Report on Sustainable and Responsible Investing Trends in the United States 2012 (executive summary), 2012, p. 11. http://ussif.membershipsoftware.org/files/Publications/12_Trends_Exec_Summary.pdf.

2 The definition of responsible investing used for this measurement is based on assets using one or more of three responsible investment strategies—screening, shareholder advocacy and community investing. Some commentators have expressed the view that because there are other responsible investing practices not included in the SIF definition, actual responsibly-managed assets could exceed SIF estimates. Id. at p. 12.

3 Just over $1.1 trillion in overlapping assets were eliminated to avoid double counting in arriving at the final total.

4 Social Investment Forum, 2005 Report on Socially Responsible Investing Trends in the United States, January 24, 2006, pp. iv, v, 1. http://ussif.membershipsoftware.org/files/Publications/05_Trends_Report.pdf. The Social Investment Forum was the predecessor to the US SIF Foundation.

extent that they are material to the investment performance of a particular portfolio. Investors are encouraged to analyze ESG issues alongside traditional indicators of risk and opportunity when making an initial investment and to become active owners once an investment is made, engaging companies and managers about potential material ESG exposures and opportunities.

PRI states that the influence of ESG factors on an institution's investment process is dynamic, and that ESG issues "can affect the performance of investment portfolios (to varying degrees across companies, sectors, regions, asset classes and through time)."[5] It also asserts that integrating ESG considerations into the fundamental investment process is consistent with traditional concepts of investment analysis. As one scholar puts it:

> Why would it not be logical from a common sense perspective to consider parts of ESG datasets?" If investment analysts are researching human capital intensive industries, would they not be interested in understanding employee motivation? If investment analysts are researching environmentally sensitive firms in the European Union, would they not be interested in understanding the costs and implications of European climate change legislation?

Today, PRI has about 1,200 signatory institutions around the world[6], representing some $34 trillion in assets under management, or 15 percent of the world's investable assets, up from $4 trillion at its launch in 2006. Most of the signatories are in northern Europe, but the single most-represented country in terms of the number of signatories is the U.S., where the rate of growth in accessions is also the highest. About 75 percent of PRI signatories are investment management firms.[7]

Part II Common Concerns about Responsible Investing

Discussions about whether responsible investing strategies help or hurt investment performance are complicated by the fact that, as noted earlier, there are several broad categories of responsible investing practice and they influence portfolios in different ways.

Partly because of their past experience with SRI and partly because ESG investing has only recently become more widespread, many institutions rightly have concerns about whether and how to apply ESG investing practices to their portfolio. The most common concerns relate to the impact of ESG investing on performance, its interaction with fiduciary duty and its application to different asset classes. This section, through a review of recent studies and academic papers, attempts to provide some context for considering these concerns.

ESG Investing and Investment Performance

Preliminary studies suggest that while integrating ESG issues into fundamental investment analysis procedures can improve investment performance, it is too early to draw comprehensive conclusions. ESG skeptics point to the efficient market hypothesis, which holds that available information about potential investments is rapidly assimilated and reflected in security prices, and argue that if ESG issues were truly material they would already be integrated into most investors' fundamental evaluation process. ESG proponents counter that if the efficient market hypothesis operated as its adherents claim there would be no material advantage in choosing companies with strong ESG characteristics and that it is precisely because ESG analysis has not been fully integrated into mainstream investment procedures that it represents such an opportunity now. As the methods for identifying which ESG issues are truly material to which investments become more refined, more useful studies will no doubt be produced on the impact of integrating these considerations into the portfolio.

A more immediate challenge is the relatively low quality of the underlying ESG data being reported by companies. No consistent standards or reporting methods exist, and as a result it is difficult for investors to compare investments with confidence. Users of ESG data are continuing to call for more standardized reporting mechanisms to improve the quality of data that is at the heart of any analysis of risk and materiality.

This push for data is important, because the existing research literature seems broadly supportive of ESG's claims. A 2012 meta-study of ESG practices[8] examined more than 100 academic studies of responsible investing around the world and also examined and categorized 56 research papers, two literature reviews and four other meta-studies. Dividing its analysis into separate categories of SRI, corporate social responsibility (CSR) and ESG, the study found that "CSR and most importantly, ESG factors are correlated with superior risk-adjusted returns at a securities level."[9] The study also reported that 100 percent of the academic studies analyzed confirmed that corporations with high ratings for CSR and ESG factors have a lower cost of capital in terms of debt and equity, while 89 percent of studies showed that companies with high ratings

5 U.N. Principles for Responsible Investing, "The Six Principles". http://www.unpri.org/about-pri/the-six-principles/.

6 Commonfund became a signatory to the Principles in February 2013.

7 U.N. Principles for Responsible Investing, "PRI Fact Sheet". http://www.unpri.org/news/pri-fact-sheet/.

8 DB Climate Change Advisors (Deutsche Bank Group), Sustainable Investing: Establishing Long-Term Value and Performance, June 2012. http://www.dbcca.com/dbcca/EN/_media/Sustainable_Investing_2012.pdf.

9 Id. at p. 5.

for ESG factors exhibit market-based outperformance and 85 percent demonstrated accounting-based outperformance.[10] Of note, the study also observed that the concept of ESG investing has taken a long time to gain acceptance because it was historically associated with exclusionary investing (i.e., negative screens) rather than with positive or best-in-class investing.[11]

Another study[12] highlights the long-term nature (approximately 20 years in some cases) of some ESG risk factors. The study compared a matched sample of 180 companies, 90 of which the authors classified as "high sustainability" firms and 90 as "low sustainability" firms, in order to examine issues of governance, culture and performance. Findings for an 18-year period showed that high sustainability firms dramatically outperformed the low sustainability ones in both stock market and accounting measures. The results suggested, however, that this outperformance occurs only in the long term. Managers and investors hoping to gain a competitive advantage by adding sustainability practices to an organization's strategy appear unlikely to obtain short-term outperformance.

This study points out a key issue with much of the ESG investing research and discussion to date: how long is the long term? Different analysts have different perspectives on how long it takes to confirm an impact from ESG risk factors. The time-frame also varies depending on what types of risk the ESG analysis is identifying. Is it the risk of an explosion at a chemical plant resulting from unsafe working conditions, which can happen at any time? Or is it the risk arising from population shifts from rural towns to urban centers that will change the pattern of demand for services, which will evolve over the next twenty years or longer? It may be for this reason that, as we discuss later, even long-term investors such as endowments and foundations have been slow to embrace ESG.

Recent research from MSCI[13] takes a more detailed look at different methods of integrating ESG analysis into portfolio construction. The authors examined three methods of applying ESG analysis to the portfolio: (i) ESG exclusion; (ii) ESG tilt; and (iii) ESG momentum. With ESG exclusion, the model presumed that after rating securities based on ESG factors the investor would simply exclude the worst-rated candidates from the portfolio. In the ESG tilt strategy, the highest-rated securities in ESG terms were overweighted in the portfolio and lower-rated ESG securities underweighted, but no securities were excluded outright. In the ESG momentum strategy, the portfolio weightings were based on changes in ESG ratings rather than on absolute ESG scores. If a company showed consistent improvement in its ESG score over a 12-month period it was overweighted in the portfolio, while a company with a negative trend was underweighted. This ESG momentum strategy was the most effective of the three during the roughly four-year time period analyzed.[14] Despite the brevity of the time period and the fact that past performance does not indicate future results, this research provides an interesting example of the more sophisticated ESG analysis that is currently being developed.

Fiduciary Duty

The studies just reviewed suggest that, when identified in an industry- and sector-specific way, ESG issues can be material to investment performance. For many investors, however, the question of whether ESG investing is compatible with fiduciaries' legal duties of care, loyalty and responsibility[15] is central. In a separate part of this paper, we analyze the implications for ESG investment practices of the Uniform Prudent Management of Institutional Funds Act (UPMIFA), which establishes uniform standards for the management, investment and expenditure of donor-restricted funds. In this section, we take note of other statutes and legal developments inside and outside the U.S. These sources appear to agree that an analysis that focuses on ESG issues can be consistent with fulfillment of a fiduciary's responsibilities.[16]

Recognition of the significance of ESG factors appears to be growing in the U.S. The investment policy and proxy voting guidelines of several state pension funds – for example, those of the New York State Common Retirement Fund[17], California Public Employees' Retirement System[18] and the Connecticut Retirement Plans and Trust Fund[19] – require consideration of ESG factors. ESG factors are also increasingly being recognized by the U.S. Securities and Exchange Commission, which issued guidance in 2010 on disclosure of climate risk

10 Id.

11 Id. at p. 6.

12 Eccles, Ioannou and Serafeim, The Impact of a Corporate Culture of Sustainability on Corporate Behavior and Performance. Harvard Business School, November 2011. www.hbs.edu/faculty/Pages/download.aspx?name=12-035.pdf.

13 Nagy, Cogan and Sinnreich, Optimizing Environmental, Social, and Governance Factors in Portfolio Construction, MSCI, December 2012. http://www.top1000funds.com/wp-content/uploads/2013/01/Optimizing-ESG-Factors-in-Portfolio-Construction.pdf.

14 The analysis covered the period between February 2008 and June 2012.

15 Sometimes also characterized as care, loyalty and obedience.

16 Another, more challenging, question is whether other forms of responsible investing, such as impact investing, are consistent with fiduciary duty to the extent that they represent a trade-off between investment performance and mission. But even in this area, the trend seems to be to reconcile fiduciary duty and impact investing. See Gary, "Is it Prudent to Be Responsible? The Legal Rules for Charities That Engage in Socially Responsible Investing and Mission Investing", Northwestern Journal of Law & Social Policy, Volume 6, Issue 1, Winter 2011, p. 106. http://scholarlycommons.law.northwestern.edu/njlsp/vol6/iss1/3.

17 Proxy Voting Guidelines, January 2011, pages 16 – 26, http://www.osc.state.ny.us/pension/proxyvotingguidelines.pdf.

18 CalPERS' Total Fund process for integrating ESG, http://www.calpers-governance.org/investments/home.

19 Connecticut Retirement Plans and Trust Funds, Investment Policy Statement, p. 14 and Appendix A, p.3 and Appendix B, Section XIII, January 9, 2013, http://www.state.ct.us/ott/pensiondocs/IPStatement.pdf.

information by publicly-listed companies.[20] Historically, public company disclosure requirements have not included reporting of non-financial sustainability data. Now, investors and some experts have suggested that the SEC should require the disclosure of non-financial data, including ESG data, to the extent that they are material to investors' decision-making process.[21] Regulators, industry associations, investment firms and institutional investors have begun to develop industry-specific methods for determining materiality as it relates to ESG issues using a metric called key performance indicators, or KPIs. The Sustainability Accounting Standards Board (SASB),[22] a nonprofit organization supported by foundations and corporations concerned about sustainability issues, is also developing industry-specific sustainability accounting standards that public companies can use to report on ESG issues in their required disclosure filings with the SEC.

Outside the U.S., many countries already have in place legislation that requires consideration of ESG issues in the management of pension assets or by investment funds. For example, the U.K. Pensions Act (2000) requires pension funds to disclose how they account for sustainability factors in constructing their investment portfolios. Germany requires the use of sustainability criteria as part of the fiduciary's duty, and France requires public pension funds to disclosure how their investment policy guidelines address social and environmental issues. Australia's Financial Service Reform Act requires superannuation (i.e., retirement) and mutual funds to disclose the extent to which ESG considerations are taken into account.[23] And South Africa mandates that institutional investors, including pension funds, "before making an investment into and while invested in an asset, consider any factor which may materially affect the sustainable long-term performance of the investment, including those of an environmental, social and governance character."[24]

At the supranational level, the United Nations Environment Programme Finance Initiative released a landmark report in 2005[25] surveying the relevant law in several countries, including the United States. The report concluded that, in the U.S. context, "there appears to be a consensus that, so long as ESG considerations are assessed within the context of a prudent investment plan, ESG considerations can (and, where they affect estimates of value, risk and return, should) form part of the investment decision-making process." The senior author of the Freshfields report has said that "Far from preventing the integration of ESG considerations, the law clearly permits and, in certain circumstances, requires that this be done."[26] A subsequent update to this influential report, issued in 2009, reiterated the view that "responsible investment, active ownership and the promotion of sustainable business practices should be a routine part of all investment arrangements."[27]

ESG Usage and Application of ESG Principles to Different Investment Strategies

ESG Usage Among Different Types of Nonprofit.

A brief review of recent research among different types of endowed nonprofit organizations, summarized in the table on the following page, illustrates the differences in ESG practice between the higher education sector, operating charities (cultural, religious and social service organizations) and private foundations.

20 U.S. Securities and Exchange Commission, "Commission Guidance Regarding Disclosure Related to Climate Change", February 8, 2010. 17 CFR Parts 211, 231 and 241. http://www.sec.gov/rules/interp/2010/33-9106.pdf. Some members of Congress have challenged the SEC guidance and proposed legislation reversing it.

21 Id. at p. 7.

22 http://www.sasb.org/.

23 Global CSR Disclosure Requirements, Initiative for Responsible Investment, http://hausercenter.org/iri/about/global-csr-disclosure-requirements.

24 Hawley, Johnson and Waitzer, "Reclaiming Fiduciary Duty Balance", Rotman International Journal of Pension Management, Vol. 4, Issue 2, Fall 2011, p. 11 and footnote 35. http://www.rijpm.com/article/reclaiming-fiduciary-duty-balance.

25 U.N. Environmental Programme Finance Initiative, "A legal framework for the integration of environmental, social and governance issues into institutional investment", 2005. http://www.unepfi.org/fileadmin/documents/freshfields_legal_resp_20051123.pdf. This document is frequently cited as the "Freshfields Report", in reference to the U.K.-based international law firm that authored it.

26 U.N. Environmental Programme Finance Initiative, Press Conference Remarks by Paul Watchman, October 25, 2005. http://www.unepfi.org/events/2005/roundtable/press.

27 U.N. Environmental Programme Finance Initiative, "Fiduciary Responsibility: Legal and practical aspects of integrating environmental, social and governance issues into institutional investment", 2009, p. 10. http://www.unepfi.org/fileadmin/documents/fiduciaryII.pdf.

Characteristics of ESG Usage Among Colleges and Universities, Cultural, Religious and Social Service Organizations and Private Foundations*

Numbers in percent (%)	Colleges and Universities	Cultural Institutions	Religious Institutions	Social Service Organizations	Private Foundations
Total Institutions	831	31	18	19	140
Use ESG criteria for portfolio	18	7	61	16	17
Environmental	5	3	6	11	5
Social	15	3	56	11	11
Governance	4	0	6	0	6
Other	3	0	6	0	4
None	71	87	33	84	79
No answer/uncertain	11	6	6	0	4

*Multiple responses allowed.

Source: NACUBO-Commonfund Study of Endowments, Council on Foundations-Commonfund Study of Investments for Private Foundations and Commonfund Benchmarks Study of Operating Charities. For educational institutions the fiscal year end is June 30, 2012; for operating charities and foundations the fiscal year end is December 31, 2012.

Among U.S. institutions of higher education, the 2012 NACUBO-Commonfund Study of Endowments (NCSE) reported that 18 percent of the 831 responding institutions used at least one of the ESG criteria in managing their portfolio. Social criteria were used by 15 percent of institutions, with environmental and governance criteria being used by only 5 and 4 percent, respectively. Among the group using ESG criteria, SRI-type measures such as negative screens were used for just over 60 percent of the investment portfolio, with only negligible use of impact investing and sustainability investing reported, while just under half of the ESG group voted its proxies consistent with ESG criteria. In describing their relationship with their portfolio manager on ESG issues, 56 percent of respondents using ESG reported that the manager integrated ESG criteria into the process of managing the portfolio and 59 percent of that group said that integration of ESG criteria was an essential factor in hiring the manager. At the operational level, 72 percent of the ESG group reported that ESG investing is a formal institutional policy, while an additional 18 percent said that use of ESG was at the manager's discretion (10 percent gave no answer or were uncertain).

Among U.S. operating charities (cultural, religious and social service organizations), the 2012 Commonfund Benchmarks Study of Operating Charities reported that use of ESG criteria varied markedly by type of organization. Sixty-one percent of religious organizations stated that they used at least one of the criteria with social criteria being by far the most widely used, by 56 percent of responding organizations, and 6 percent each reporting use of environmental and governance criteria. Among social service organizations, in contrast, only 16 percent of respondents reported using one of the criteria, with 11 percent each reporting use of environmental and social criteria and none using governance criteria. Among cultural organizations use of ESG standards was negligible, with just 3 percent each using environmental and social criteria and, again, none using governance criteria. With respect to the study as a whole, among the group using ESG criteria, negative screens were used for over 78 percent of the investment portfolio with very little use of impact investing and sustainability investing reported, while 50 percent of the ESG group voted its proxies consistent with ESG criteria. In describing their relationship with their portfolio manager on ESG issues, 63 percent of respondents using ESG reported that the manager integrated ESG criteria into the process of managing the portfolio and 80 percent of that group said that integration of ESG criteria was an essential factor in hiring the manager. Seventy-four percent of the ESG group reported that ESG investing is a formal institutional policy, while an additional 13 percent said that use of ESG was at the manager's discretion (13 percent gave no answer or were uncertain).

Among U.S. private foundations, the 2012 Council on Foundations-Commonfund Study of Investments for Private Foundations (CCSF) reported that use of ESG criteria is also limited, with 17 percent of responding institutions saying that they use ESG in their investing process. Of this group, 11 percent cited use of social criteria, while just five percent reported using environmental criteria and six percent used governance criteria. Among the group using ESG criteria, negative screens were used for about six percent of the investment portfolio with just over one-quarter used for impact investing and about 18 percent used for sustainability investing.

Application of ESG to Different Investment Strategies.

ESG investing practices have traditionally been applied most broadly to publicly traded equities. The approaches to integrating ESG analysis into fundamental research are, therefore, most developed in the field of equity investment. Recent ESG techniques take into account the specifics of a company's

ESG Investment Practices Used Among Colleges and Universities, Operating Charities and Private Foundations

Numbers in percent (%)	Colleges and Universities	Operating Charities[1]	Private Foundations
Responding Institutions	149	16	23
Percentage of total portfolio dedicated to:			
Negative screening	60.1	78.6	5.9
Impact investing	*	*	25.9
Sustainability investing	*	*	17.8
Vote proxies consistent with ESG criteria	49	50	N/A
Portfolio managers integrate ESG criteria	56	63	N/A
Integration of ESG was essential in hiring manager	59	80	N/A
ESG is a formal institutional policy	72	74	N/A
ESG is at manager's discretion	18	13	N/A

[1]Cultural, religious and social service organizations. Sample size of responses by individual segment was too small to analyze.

*Sample size too small to analyze. N/A = not asked

Source: NACUBO-Commonfund Study of Endowments, Council on Foundations-Commonfund Study of Investments for Private Foundations and Commonfund Benchmarks Study of Operating Charities. For educational institutions the fiscal year end is June 30, 2012; for operating charities and foundations the fiscal year end is December 31, 2012.

operations and geography and attempt to narrow the universe of ESG issues to those that are significant enough to affect investment performance on a company, industry or sector basis. Different analysts and organizations have developed different methods of identifying key ESG issues. SASB bases its materiality analysis on the definition of materiality developed by U.S. securities regulators,[28] while MSCI's Intangible Value Assessment tool uses a matrix of key environmental, social and governance issues that it applies selectively to different companies.[29]

Fixed income investing is also beginning to receive more attention from ESG investors. MSCI and Barclays have joined forces to release a fixed income ESG index and are creating a database for fixed income securities, including sovereign debt.[30]

The broad category of alternative investments – marketable alternatives (hedge funds), private equity, venture capital, natural resources, commodities, real estate, and distressed debt, among others – pose challenges to traditional ESG analytical methods because of the relatively opaque nature of their investment processes. While these strategies have not historically lent themselves to ESG analysis, more alternative strategy managers are becoming cognizant of ESG issues. The 2012 US SIF Trends Report stated that, overall, alternative assets managed in accord with ESG principles grew by 250 percent from 2010 to 2012, reaching an estimated total of $132 billion.[31]

A number of the early signatories to the UN PRI were private equity firms, which tend to exercise more control over their portfolio companies than managers investing in publicly traded securities and which adhere to an investment process requiring a long-term investment horizon. While some private equity managers have adopted ESG principles in their mainstream business, others have created targeted ESG investment funds. In 2008, for example, private equity firm KKR launched its Green Portfolio Program, comprising 24 portfolio companies focused on improving their environmental and business performance around the world. From 2008 through 2011, through efforts in energy and water efficiency, waste management and operational improvements, the portfolio companies reported significant reductions in greenhouse gases and solid waste, along with reductions in water use.[32]

More recently, UN PRI and a group of more than 40 limited partners, 20 private equity industry associations and 10 leading general partners have published a new ESG disclosure framework for private equity.[33] The framework is aligned with the PRI's efforts to encourage informed and systematic dialogue between general partners and limited partners in

28 Sustainability Accounting Standards Board, "Determining Materiality". http://www.sasb.org/materiality/determining-materiality/.

29 MSCI Inc., "MSCI ESG Intangible Value Assessment", February 2013. http://www.msci.com/resources/factsheets/MSCI_ESG_IVA.pdf.

30 http://www.msci.com/products/esg/fixed_income/.

31 US SIF Foundation, Id. at p. 13.

32 http://green.kkr.com/results.

33 U.N. Principles for Responsible Investing, "Environmental, Social and Corporate Governance (ESG) Disclosure Framework for Private Equity", March 25, 2013. http://www.unpri.org/wp-content/uploads/13161_ESG_Disclosure_Document_v6.pdf.

ESG and UPMIFA: Clear and Complementary

Is ESG practice compatible with the Uniform Prudent Management of Institutional Funds Act (UPMIFA)?[1] UPMIFA, now the law in 49 states and the District of Columbia, does not address ESG concerns directly. But the fiduciary regime prescribed by UPMIFA can be viewed as consistent with an investment approach that systematically takes into account ESG concerns as part of an analysis aimed at maximizing long-term investment return. At a more specific level, moreover, UPMIFA is sympathetic to investment practices that include environmental – or, more specifically, sustainability – analysis and that also place a premium on good governance.

Environmental and sustainability matters. UPMIFA assumes that a donor, in creating an endowed fund, acts with the intention of establishing what the law refers to as a "fund of permanent duration." This means that unless the gift instrument specifies otherwise, the life of the fund is meant to be perpetual. The statute also assumes, in the absence of donor instructions to the contrary, that a donor's purpose in creating a fund is to support a certain level of charitable activity into the indefinite future. Thus, in the words of the UPMIFA drafting committee's commentary on the law, "the Act assumes that the charity will act to preserve "principal" (i.e., to maintain the purchasing power of the amounts contributed to the fund) while spending "income" (i.e., making a distribution each year that represents a reasonable spending rate, given investment performance and general economic conditions)."[2]This balanced approach, in which purchasing power is preserved into perpetuity while a reasonable distribution is made each year, speaks strongly to notions of sustainability. UPMIFA supports the sustainability of institutional missions over time by assuming, unless donors specify otherwise, that a fund is one of permanent duration and that the work that is done on the day the fund is established is meant to be sustained into the future.

1 The text of the uniform law and the commentary of the drafting committee are available at http://www.upmifa.org.

2 Uniform Prudent Management of Institutional Funds Act (UPMIFA), Commentary to §4. http://www.uniformlaws.org/shared/docs/prudent%20mgt%20of%20institutional%20funds/upmifa_final_06.pdf, p. 21.

private equity funds about how ESG factors are considered in private equity investment activities. The document outlines eight objectives encompassing a structured approach to ESG disclosures for limited partners in private equity investments. The first five objectives relate to the fund due diligence process and the remaining three concern disclosures during the life of the fund. Guidance is also provided regarding disclosure of information about unexpected events that might pose reputation risks to a general partner, limited partner or portfolio company. Other efforts are ongoing to refine ESG due diligence in the private equity arena.

Marketable alternative (hedge fund) managers are also taking note of investors' interest in ESG criteria. Their investment horizon is generally much shorter than that of private capital investors, giving them less incentive to consider – or benefit from – incorporating longer-term ESG principles into their investment process. Another challenge for these managers is whether, and how, ESG factors can be part of strategies that include short sales of securities and the use of derivatives. Consideration of these issues is in the early stages, but managers and ESG analysts are beginning to think about these questions as they face increased interest from investors.

More improved tools are being developed for analyzing ESG factors across different types of investment portfolios. The process is still in its early stages, but recent developments show a new and potentially promising level of sophistication.

Part III
Integration of ESG Factors: Some Practical Steps

In the current climate of slow global economic growth and resource constraints at many institutions, implementation of ESG considerations in an organization's investment portfolio may be perceived as a luxury or an unacceptable distraction. ESG implementation does not, however, need to be an all-or-nothing decision. Rather, a sliding scale of engagement is available for institutions that decide to explore ESG issues.

As a first step, the board of trustees may create a working group, in the form of a subcommittee of the board or investment committee, to research the relevant issues and determine the potential application of ESG processes and principles to the institution's investment portfolio. If the board thinks it appropriate, it may also convene an advisory group of stakeholders from the broader community (for example, student or faculty representatives at a university or beneficiaries of a pension fund) to inform the committee's efforts. Some institutions may also find it useful to retain an advisor with expertise in ESG matters to perform an initial analysis of the portfolio in order to determine a baseline of exposure to defined ESG issues.

As the institution's experience with ESG analysis develops, it may want to put in place procedures for measuring and monitoring its exposure to ESG factors on an ongoing basis. Since there is no single standard for ESG measurement, each institution will need to determine, based on its own mission goals, investment policy considerations, donor preferences and spending needs, the appropriate handling and communication of ESG issues, both internally and externally.

Some of the factors that an institution may want to consider – on a sliding scale from the least resource-intensive to the most—are the following:

Manager Due Diligence

If the institution is working with third-party investment managers, it could add to the standard list of due diligence questions some inquiries about how the manager examines ESG issues. Some examples might be:

- Does the manager integrate analysis of financially material environmental, social and governance issues into its investment process?
- If so, please describe the manager's approach to assessing ESG risks and opportunities.
- Provide a copy of any existing ESG policy.
- How has analysis of ESG issues affected the manager's portfolio design?
- Provide an example of how ESG factors have affected specific investment decisions.
- How does the manager monitor ESG risks across its portfolios on an ongoing basis?
- Has the manager signed the U.N. Principles for Responsible Investment and, if so, what steps has the firm taken to implement PRI?
- For private equity managers or control investors, request comment on their approach to engaging with management of portfolio companies on material ESG issues.

ESG and UPMIFA: Clear and Complementary

(continued from page 8)

Good governance is also supported by the processes set forth in UPMIFA for managing donor-restricted funds. While the law does not address governance standards for companies in which the charity might invest, it does provide a clear road map for investing, spending and delegation in the form of lists of issues which must be considered by the charitable fiduciaries. These issues include not only economic and investment return-related matters but more nuanced concerns such as "the needs of the institution and the fund to make distributions and to preserve capital; and . . . an asset's special relationship or special value, if any, to the charitable purposes of the institution."[3] The selection and oversight of agents such as managers and consultants are covered by other sections of the law. These governance practices, mandated by UPMIFA at the fiduciary level, can be read as endorsements of method and consistency at the portfolio level as well.

Sustainability and good governance are thus present in UPMIFA in their appropriate spheres of regularity, consistency and transparency of process in the oversight of donor-restricted funds. UPMIFA helps fiduciaries to understand what they must do in order to reasonably assure themselves that they are in compliance with the law and with prudent standards of good governance.

Finally, while UPMIFA does not speak explicitly to social issues, a central purpose of the law is to increase the likelihood that the social benefit derived from a fund will be realized into perpetuity. In the words of the drafters, "This approach allows the charity to give effect to donor intent, protect its endowment, assure generational equity, and use the endowment to support the purposes for which the endowment was created."

3 Id. §3(e)(1)(G)-(H) at p. 12.

Investment Policy Statement

As a follow-on to these manager conversations, the board of trustees (or the relevant committee) may want to consider integrating analysis of ESG issues into the construction and monitoring of its investment portfolio. The process of designing an investment policy that incorporates ESG considerations will enable the institution to address ESG issues as they apply to different asset classes and investment strategies, and to think carefully about how to craft a policy that fits the institution's goals.

Require That Managers Affirmatively Consider ESG Issues

The institution could require that its managers apply ESG analysis to their investment processes. The institution could:

- Include ESG criteria in its requests for proposals
- Require provisions in side letters or investment management agreements that describe the steps the manager will take regarding consideration of ESG issues in the investment process
- Require monitoring and reporting to the institution on ESG considerations related to the portfolio
- Set standards against which the manager must report on the integration of ESG factors
- Require that the manager reflect ESG considerations in its proxy voting policy

Manage ESG Exposures Across Portfolios

In addition to managing ESG considerations on an investment-by-investment basis, the institution may want to examine the investment portfolio as a whole and analyze aggregate exposure to ESG considerations.

Some managers, including those that have become signatories of the PRI, are already in the process of employing many of these strategies for their direct investment portfolios. For investment outsourcing firms and managers of managers, the process would involve working with their underlying managers and sub-advisors on ESG issues and defining the approach that is most appropriate for different investment strategies and asset classes.

Conclusion

The responsible investing landscape is changing. Formerly limited to SRI processes characterized by negative screens, responsible investing now sees an increasing emphasis on research techniques that emphasize positive environmental, social and governance factors. Strengthening the intellectual case for ESG is the recognition by lawmakers and regulators that ESG analysis can be consistent with, or even bolster, traditional fiduciary responsibilities. Some commentators have gone so far as to suggest that ESG will eventually become incorporated into general research techniques to the extent that it will essentially "disappear" as a separate process.[34] Whether or not a particular institution decides to add ESG practice to its investment toolkit, fiduciaries will need to bear in mind its presence and, potentially, its increasing influence and visibility.

34 Ambachtsheer, "The 'Responsible Investment' Movement: Has It Ceased to Exist Yet?", The Ambachtsheer Letter, June 2013 (by subscription; excerpted at http://www.kpa-advisory.com/pdf_documents/327_the_responsible_investment_movement.pdf).

Sources of Information

Fiduciaries and staff who are considering integrating ESG factors into their investment decisions should first review the investment- and mission-related issues that are important to their institution. Individuals or groups spearheading such an effort may find the following websites useful.

ESG Investing

- Ceres (www.ceres.org)
- The Hauser Center for Nonprofit Organizations at Harvard University (www.hausercenter.org)
- Investor Responsibility Research Center Institute (http://www.irrcinstitute.org)
- Sustainability Accounting Standards Board (www.sasb.org)
- Tellus Institute (www.tellus.org)
- United Nations Principles for Responsible Investing (www.unpri.org)

SRI

- The Forum for Sustainable and Responsible Investment (formerly the Social Investment Forum) (www.ussif.org)

Impact Investing

- Global Impact Investing Network (www.thegiin.org)
- The Sustainable Investment Research Institute (SIRIS) (www.siris.com.au)

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