Breakout Panel Discussion:

SRI Investing:

SRI, ESG, and Impact Investing – what do they mean for your portfolio in terms of legal concerns, IRR, risks and values.

Moderator:

John C. Furlow Jr., Texas Presbyterian Foundation

Panelist:

Allen Campbell, ConsientiousInvesting.com

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21st National Pension and Institutional Investor Summit
Tuesday, November 17, 2015

QUICK OVERVIEW OF SOCIALLY RESPONSIBLE INVESTING

The National Society of Institutional Investment Professionals, Summit 2015

Allen F. Campbell, J.D., M.B.A.

November 20, 2015

Four Primary Considerations

When dealing with the construction and maintenance of an investment portfolio, the whether and how of SRI involves these considerations:

- Values — define us, and provide our motivation.
- Legality — being in compliance with applicable law.
- Rate of return — as commonly understood.
- Risk — as commonly understood and measured: safety of principal, diversification, volatility, etc.

From a Big Picture point of view, they are the main considerations as to any investment program.

Values and ESG Factors

- The first SRI values were religious, avoided sin stocks, like alcohol and tobacco.
- In recent years SRI values are more often secular, commonly environmental, social and governance (“ESG”) factors.
- Many organizations are trying to find out if there are specific ESG factors that are associated with better-than-market performance.
- The assets and activities of companies typically involve many factors. It’s hard to score them.

Dealing with Values

- In an organizational setting, it is likely that the primary values have been established in one or more documents that set up the organization or fund.
  - Examples: to fund workers' retirement, to support acquisitions of art, to build or maintain infrastructure.
- Is there latitude for other values to be considered?
- If so, how do you determine what they are?
  - Ascertain the donor's actual or presumed values?
  - Can or should the committee or board of trustees employ their individual or collective values?
- "Values" are commonly stated in general terms. Applying values to real-life companies and situations is challenging.

Legal Concerns

- Be aware of your fiduciary duties.
- As a trustee or other fiduciary, am I permitted to make portfolio decisions based on considerations other than the traditional considerations, such as rate of return, safety of principal, and diversification?
- Rights and duties are established by the originating documents – e.g., trust indenture – by statute, by common law, by regulatory agencies and by the IRS.
- Legality is a function of many facts and circumstances, such as the nature of the entity, which state's law applies, and which agencies have regulations that apply.
- SRI investing was historically barred by fiduciary responsibility standards, but there is increasing flexibility.

Conscientious Investing: Basic Outline of Process for Investment Professionals

- It can be useful to hire a consultant to facilitate the process.
- Get preliminary legal guidance regarding the rules applicable to the portfolio.
- If it's OK to proceed, then
  - Decide which values (ESG factors, religious values, etc.) are to be factored in.
  - An organization with special interest in a topic can be a resource, e.g., PETA on animal rights.
  - Determine the approach to be taken. Principal options :
    - Exclude specific stocks, industries, considerations?
    - Over-weight specific stocks, industries, factors?
    - Buy an SRI index or SRI fund?
    - Buy a fund that includes SRI considerations in selecting companies that are expected to perform well in the long run; the decision is economic but informed by SRI analysis.
  - Settle on the relevant non-SRI benchmark, e.g., S&P 500.
  - Assess economic consequences of the suggested SRI strategy (probably by back-test); compare it to the relevant benchmark.
  - If the SRI strategy performs as well as or better than benchmark, then proceed.
  - If not, then quantify the magnitude of the difference: how many dollars will be lost if the most profitable alternative is not chosen, and what the implications for the organization's operations. Write up the facts and analysis in a report that clearly states the alternatives, the considerations favoring each alternative, and the consequences.
  - Make the decision. The investment committee, and perhaps also the board, should use the report to help guide decision making. The reasons for the decision should be explicitly stated.
  - Document the entire process. Include a legal opinion in the file.

ERISA : Basic Rule

- ERISA presents special challenges to SRI investing.
- Under ERISA the primary responsibility of a plan fiduciary charged with managing plan investments is to benefit participants and beneficiaries by making prudent and sound investments (including diversification of plan investments) rather than furthering a social responsibility agenda.

ERISA: New Interpretive Bulletin (1)

- A new DOL Interpretive Bulletin, promulgated October 22, 2015, deals with “economically targeted investments” (“ETIs”), i.e., investments that are selected, in part, for their “collateral benefits”, i.e., benefits apart from the investment return to the employee benefit plan investors. The IB clarifies that factors often associated with ETIs, including environmental, social and governance (“ESG”) factors, “*may* have a direct relationship to the economic value of investments” and therefore *may* be considered in a fiduciary’s primary economic analysis of plan investments.
- While the IB may be intended to remove barriers to ETIs, the DOL was careful to affirm its longstanding position that a “fiduciary may not use plan assets to promote social, environmental, or other public policy causes at the expense of the financial interests of the plan’s participants and beneficiaries.”

ERISA: New Interpretive Bulletin (2)

- The IB states: “an investment will not be prudent if it would be expected to provide a plan with a lower rate of return than available alternative investments with commensurate degrees of risk or is riskier than alternative available investments with commensurate rates of return. The fiduciary standards applicable to ETIs are no different than the standards applicable to plan investments generally. Therefore, if the above requirements are met, the selection of an ETI, or the engaging in an investment course of action intended to result in the selection of ETIs, will not violate section 404(a)(1)(A) and (B) and the exclusive purpose requirements of section 403.”

Shareholder Engagement

- This is mainly about shareholder initiatives and proxy voting.
- Institutional Shareholder Services Inc. (“ISS”) and Glass Lewis are dominant. Their proxy voting may not serve shareholder interests, and the SEC has the matter under consideration.
  - On June 30, 2014, the SEC issued a Staff Legal Bulletin 20 (“SLB 20”) which provides guidance regarding the responsibilities of investment advisers and proxy advisory firms as to voting of corporate proxies.
  - SRI investing is about deeply felt values, and it is fair to ask if and when an investor should ever “outsource its values-based decision-making”.
- Letter writing to management is commonly done by shareholders to advocate for ESG or religious values.
- Being a shareholder can be seen as being a member of a community. Does that imply being sensitive to the recognized goals of the company and its shareholders? When does activism become mere hectoring and/or attempted coercion?

Mission Investing

- Mission Investing refers to the use of investments by foundations as tools to achieve their philanthropic goals. Mission Investing Exchange uses the term Mission Investments (which it also calls Impact Investments) to mean investments by mission-based organizations that are designed to generate both a social and a financial return. There are two types:
  - Program or Program Related Investments (PRIs) are investments that are made primarily to achieve a program objective, rather than a significant financial return. PRIs, however, are expected to be repaid. For private foundations, PRIs are defined by the IRS tax code, and they are eligible to count against the 5% payout that foundations are required to make each year to retain their tax exempt status. PRIs may be made in the form of loans, loan guarantees, cash deposits, or equity.
    - Community foundations, however, are not subject to IRS restrictions in their use of program driven investments. In addition, community foundations have the flexibility to make program and other mission investments from endowment, donor advised, or unrestricted funds.
  - Mission-Related Investments (MRIs) are market-rate investments that support the mission of the foundation by generating a positive social or environmental impact, while generating reasonably competitive rates of financial return. An MRI is fundamentally a financial investment, and must meet applicable prudent investor standards just like more conventional investments. MRI opportunities exist across all asset classes including cash, fixed income, public equity, private equity and venture capital and real estate.

Mission Investing: IRS Clarification

- Under Code Section 4944 and related Treasury Regulations, a foundation (and foundation managers) may be subject to excise taxes if it makes an investment without exercising ordinary business care and prudence; a foundation must analyze each investment, in light of the portfolio as a whole, with an eye toward the long- and short-term financial needs of the foundation to carry out its exempt purposes.
- IRS Notice on 9/15/2015 clarifies that Mission Investments by private foundations in accordance with the Uniform Prudent Management of Institutional Funds Act, which is enacted and applicable to nonprofit corporations in most states, should not be considered jeopardizing investments under Section 4944.

Impact Investing

- Impact Investing is a term that is being increasingly used, although it is not clearly defined.
- One authority in the field defines Impact Investing as “purely proactive problem solving investment.”
- It is sometimes considered to be more or less synonymous with Mission Investing, as that term may be broadly defined.
- SRI in the Rockies, a leading SRI organization, now uses the SRI portion of its name to denote “sustainable”, “responsible” and “impact”.

Overzealousness?

- Proponents and opponents of SRI sometimes overstate the facts. Examples:
  - “Fiduciary duties require fiduciaries to use SRI principles.”
  - “Investing pursuant to SRI principles is more profitable.”
  - “There is necessarily a trade-off, i.e., SRI portfolios always underperform relevant benchmarks.”
- Effects of bias:
  - At the research level: it corrupts the work.
  - In the media, it puts a spin on the findings.
- Need for more, high-quality empirical evidence and for objective journalism.

Closing Thoughts

We all want a better world, but we have differing views about what that looks like and how to get there.

Professional investment management, at its best, is grounded in data, both legal and economic. My approach, Conscientious Investing, values empirical research.

My views are expressed in my blog website, www.conscientiousinvesting.com.

Contact me at allen.campbell@conscientiousinvesting.com.

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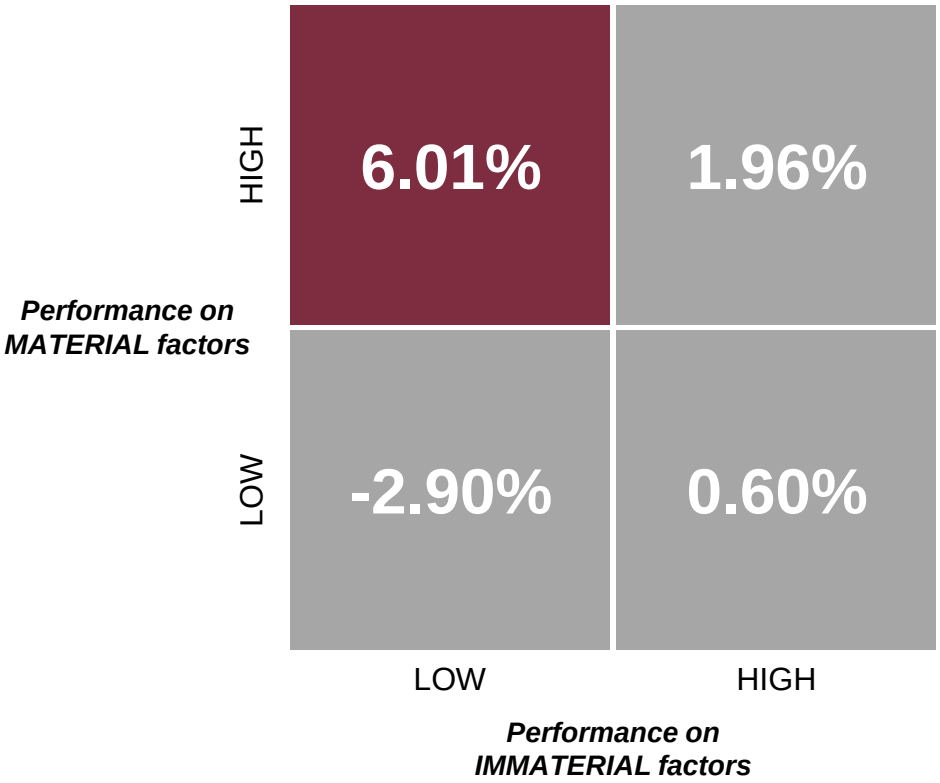
WHY ESG MATTERS?

Materiality Matters

STOCK RETURNS (IN ANNUALIZED ALPHA) BY TYPE OF SUSTAINABILITY PERFORMANCE

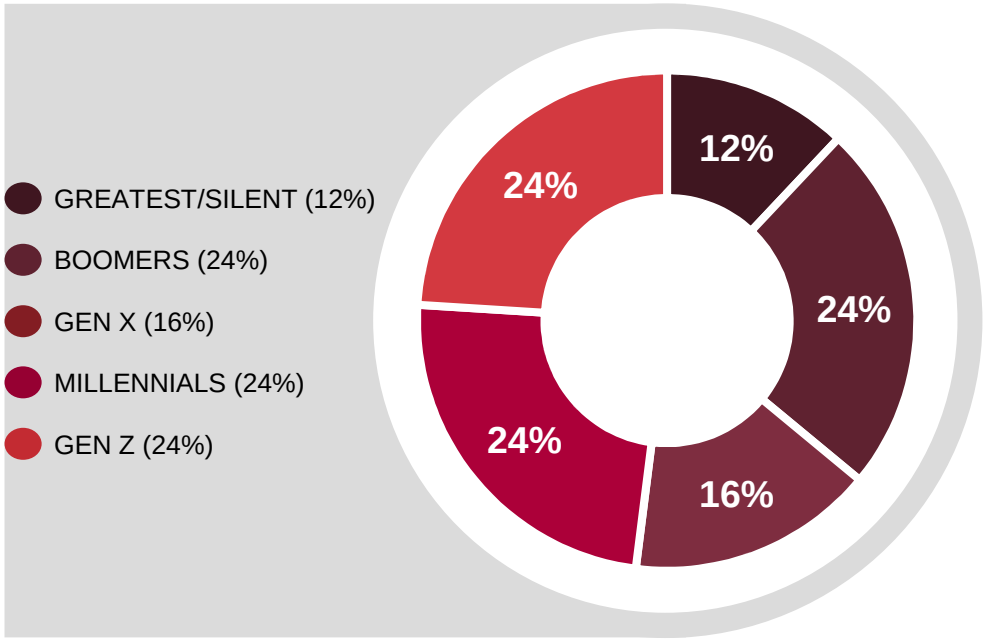


- Using SASB's framework, Harvard researchers found that **firms with good performance on *material* sustainability issues and concurrently poor performance on *immaterial* sustainability issues enjoy the strongest financial returns**. These results speak to the efficiency of firms' sustainability investments, and also have **implications for asset managers** who have committed to the integration of sustainability factors in their capital allocation decisions."
- They also found that **80 percent of disclosures are immaterial,** having no correlation to positive performance.

Source: "Corporate Sustainability: First Evidence on Materiality," Working Paper by Mozaffar Khan, George Serafeim, and Aaron Yoon, Harvard Business School, 2015 and Sustainability Accounting Standards Board (SASB), 2015

MILLENNIALS ARE THE DECISION MAKERS OF THE FUTURE

POPULATION BY GENERATION



By 2020, 1 in 3 adults will be Millennials

Millennials stand to inherit upwards of $41 trillion in baby boomer wealth

HIGH NET WORTH MILLENNIAL'S CARE ABOUT THEIR IMPACT ON SOCIETY

75%
consider the social and environmental impact of the companies they invest in to be an important part of investment decision-making.

73%
agree
It is possible to achieve market rate returns investing in companies based on their social or environmental impact

73%
agree
I would rather invest in companies that will have a positive social or environmental impact than boycott investments in companies that are harmful

67%
agree
My investment decisions are a way to express my social, political, or environmental values

Source: Nielsen Pop-Facts. 2013 (LHS), U.S. Trust: Insights on Wealth and Worth 2013 & Sustainable Signals: The Individual Investor Perspective by Morgan Stanley (RHS)

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