RESPONSIBLE INVESTING: LOOKING BACK AND OPPORTUNITIES AHEAD

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Introduction

Over time there have been substantial developments in the responsible investing area. As a result, responsible investing looks and sounds quite different from what was predominantly a negative screening approach many years ago. Today, responsible investing can be more impactful and may include active proxy voting, company engagement and public policy work. Further, responsible investing comes in many different forms that may target either market rates of return or below-market rates of return.

While many faith-based institutions were early adopters of responsible investing, endowments and foundations have also been quite active over the years. Also of note, many public pension funds have become engaged in this area and have used their significant asset bases to push for change. In general, there is a growing awareness and desire among the institutional investment community to have a greater impact through portfolio investments. One compelling opportunity that exists for private foundations is in the form of Program Related Investments (PRI). These investments allow organizations to supplement their spending and grant making with below-market rate investments that count toward the foundation's annual spending.

This increasing demand from investors has led to significant growth in the both the number of investment strategies as well as the types of products available to investors; however, some challenges remain in the form of education on the topic, benchmarking and fees. While there is no right answer as to how investment programs should approach responsible investing, the menu of options is expanding, which can allow interested investors to have a greater impact on a variety of important causes and initiatives.

The Many Flavors of Responsible Investing

Responsible investing has existed in one form or another for many years and has continued to evolve to the point where the definition is quite broad and includes many underlying subcategories. These sub-categories overlap to some degree, but include Environmental, Social and Governance (ESG), mission-related investing (MRI), sustainable investing, community investing, and program related investing (PRI).

IN GENERAL, THERE IS A GROWING AWARENESS AND DESIRE AMONG THE INSTITUTIONAL INVESTMENT COMMUNITY TO HAVE A GREATER IMPACT THROUGH PORTFOLIO INVESTMENTS

- **ESG** investing incorporates these issues into the investment decision making process as a means to enhance returns and reduce risk. Additionally, these approaches may involve active proxy voting, company engagement and public policy work.
- **Mission related investing** is similar to ESG, but is typically more focused on causes that closely align with the mission of the specific organization (e.g. faith-based institutions).
- **Sustainable investing** is generally focused on investing in companies that are addressing issues related to the conservation of natural resources (e.g. energy, air, water).

Exhibit 1: Responsible Investing Components

Responsible Investing				
Environmental, Social, & Governance (ESG) --- Example: investing with a focus on ESG; may also include proxy voting, egagement and public policy work	Mission Related Investing (MRI) --- Example: A faith based organization that invests with specific guidelines	Sustainable Investing --- Example: Investing in a Water Resources Fund	Community Investing --- Example: Investing in a community housing project	Program Related Investing (PRI) --- Example: Health related foundation investing in a company that provides healthy school lunches

Source: NEPC, LLC

- **Community investing** typically involves loans to smaller, local groups that may face challenges in accessing traditional financing. These types of arrangements often involve training and education as the lender is typically more actively engaged in helping the borrower achieve their goals.

- **Program related investing** is pursued to achieve the goals of individual charitable institution and targets a below-market rate of return. PRI is unique in the way in which the investments are accounted for by the IRS as they can count towards an organization's required spending in certain cases. *NEPC believes that PRI can be an innovative solution for many private foundations given their potential to provide incremental investment returns and allow foundations to potentially retain the investment principal. For additional information on PRI please see the "In the spotlight" section of this paper, below.*

Historically, some investors have associated responsible investing with below-market rate of return investments. While below-market rate investments may make up a portion of the responsible investing landscape, there is also a wide array of responsible investment opportunities across investment strategies that seek to meet or exceed market returns.

History of Responsible Investing

Responsible investing initially came to the forefront as different investor groups integrated negative screening into their respective investment approaches. Further, responsible investing was critical in creating awareness and action around the apartheid policies of the South African government. In other cases, faith-based institutions screened alcohol, tobacco, weapons, gambling, and/or adult entertainment stocks out of investment portfolios.

The next evolution of responsible investing moved from negative screening to positive screening, where investments were targeted towards companies that scored well on environmental, social, and governance attributes. This came to be known as ESG investing.

While engagement has long been a part of responsible investing, it has become more prevalent of late. Engagement can come in the form of active proxy voting, shareholder resolutions, public policy, and company engagement. While most shareholder proposals are non-binding, companies have typically attempted to avoid public relations issues[i].

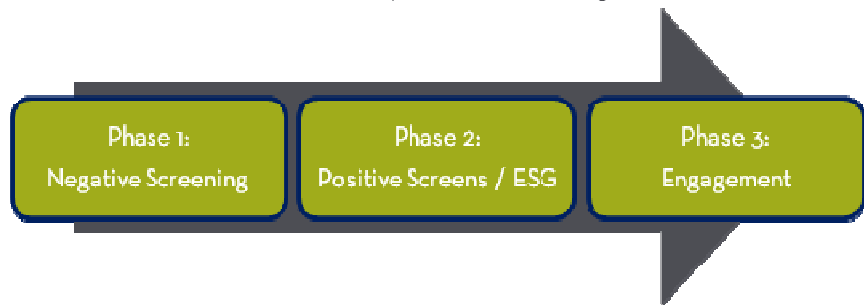
Trends in Responsible Investing - Strategies

The amount of assets classified as responsibly invested has expanded significantly over the past 15 years. The 2010 Social Investment Forum Foundation report on Socially Responsible Investing Trends in the United States indicates that approximately \$3.1 trillion in assets out of the \$25.2 trillion U.S. marketplace use some form of socially responsible investing approach[ii]. This translates to roughly 12% of the U.S. investment market. Further, responsible investing adoption outside the U.S. is somewhat higher and also growing, particularly among institutions in Europe and Australia.

More specifically, assets managed to incorporate ESG factors have experienced significant growth and are now in excess of \$2.5 trillion. Of these ESG mandates, approximately \$550 billion are implemented through mutual or commingled funds with the balance invested through separate accounts. The number of investment options has also grown exponentially as approximately 500 funds (mutual funds, ETFs, and alternative funds) fall into this category compared to roughly half

that number in 2007[iii]. This growth in funds and assets from 2007 to 2010 is partly due to the inception of new responsible investing strategies, but is largely a result of the growing utilization of ESG factors in existing strategies.

Exhibit 2: The Evolution of Responsible Investing



Source: NEPC, LLC

Based on our research at NEPC, there are many responsible investing offerings in the form of public equity and fixed income mutual funds, however, larger investors can access separate accounts to achieve specific responsible investing goals and objectives. In addition, the ETF market continues to expand with different types of offerings that address many responsible investing needs.

THE AMOUNT OF ASSETS CLASSIFIED AS RESPONSIBLY INVESTED HAS EXPANDED SIGNIFICANTLY OVER THE PAST 15 YEARS

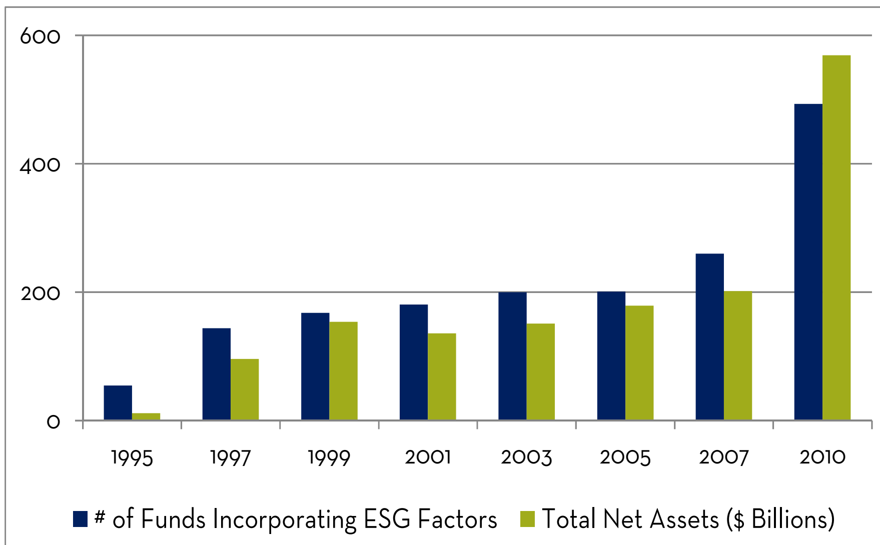
Within alternative assets, the number of hedge funds managed incorporating responsible investing is currently limited, but has been growing as a result of demand from investors as well as more willingness on the part of hedge fund managers to create responsible investing share classes. Some of NEPC's preferred hedge fund managers have either recently created responsible investing share classes or are in the process of doing so. Also within the hedge fund space, many activist oriented funds have impressive track records. It should be noted, however, that most activist approaches focus on specific governance issues to increase shareholder value, as opposed to broader ESG objectives. Private market offerings continue to grow and based on our review of the opportunity set, the number of social venture capital, private equity, infrastructure and real asset funds is significant.

Trends in Responsible Investing – Institutional Investors & Investment Managers

The increase in responsible investing strategies, funds, and security offerings has been driven in large part by demand from a number of different types of investors. Several endowments and foundations have received attention for their progressive responsible investing programs, including PRI. In addition, some public funds have become large players in the responsible investing area. Corporate pension plans have been limited participants in responsible investing as a result of concerns around ERISA and how it would apply to Plans. ERISA fiduciary duties require loyalty, diversification, and prudence amongst other things. On May 28, 1998 the Department of Labor issued an advisory opinion on responsible investing in ERISA plans. The key language of the document indicates that an investment should be made first and foremost on its investment merit and social investments should be a secondary consideration. As a result, corporate pension plans have not been active participants in the responsible investing space, but may be more active once a greater comfort level around the DOL language is achieved.

In our conversations with investment managers, it is becoming clear that while many offerings are not marketed or branded as responsible investing strategies, investment managers are often incorporating ESG metrics in their investment process. The number of managers implementing these approaches is still difficult to quantify, but if the United Nations Principles for Responsible Investment "UNPRI" signatory list is any indication, growth has been significant. The United Nations-backed Principles for Responsible Investment initiative (UNPRI) is a network of global investors working together to put the six Principles for Responsible Investment into practice. The Principles reflect the view that ESG issues can positively affect the performance of investment portfolios and therefore must be given appropriate consideration by investors if they are to fulfill their fiduciary (or equivalent) duty. The Principles provide a voluntary framework by which all investors can incorporate ESG issues into their decision-making and ownership practices and so better align their

Exhibit 3: ESG Growth



Source: Social Investment Forum

objectives with those of society at large[iv]. As of April 2012, over 1,000 investment firms with assets under management of roughly $30 trillion have signed on to the list[v]. While some of these firms are further along the implementation curve than others, it is encouraging, and a potential indicator of increased utilization of ESG metrics in the investment decision making process for many firms.

Trends in Responsible Investing - Securities

In addition to a significant increase in the number of responsible investing strategies offered, there has also been a good deal of dialogue and action around new security offerings, especially in the fixed income area. Social Impact Bonds and Green Bonds are prime examples and can offer yields competitive with broad bond market benchmarks such as the Barclays Aggregate Index. It should be noted, however, that these markets are currently in their infancy and liquidity may be a consideration in certain cases.

Social Impact Bonds, which are growing in popularity, are structured in a way that investors lend money to a project and also play a role in deployment of the project. A government sponsor, such as a state, will also play an oversight role and repay the original loan - and some of the realized savings from the project – based on the achievement of specific project goals. Social Impact Bonds have a fixed maturity; however, they do not offer a fixed rate of return. As such, they are more akin to a structured security because repayment to investors is dependent upon specified social outcomes being achieved. New York, Massachusetts and Ohio are either in the process of or have instituted programs based upon these new securities.

Another relatively new offering are World Bank Green Bonds. These securities raise funds from fixed income investors to support World Bank lending for eligible projects seeking to mitigate climate change or help those affected by it. The securities were designed in partnership with Skandinaviska Enskilda Banken (SEB) to respond to specific investor demand for triple-A rated fixed income securities that support projects addressing climate challenge. Since 2008, the World Bank has issued approximately $3 billion in Green Bonds[vi].

Responsible Investing Performance

One of the often discussed issues around responsible investing is whether it impacts investment performance. While this paper is not intended to provide additional research on the performance of responsible investing funds, we can offer a summary of the studies that have been done and our suggestions for what investors should expect from the various approaches.

Negative Screens

In cases where the responsible investing approach involves negative screening we would advise that investors expect some degree of reduced performance over the long term. The reason for this is because in limiting the opportunity set, the resulting investment has a greater likelihood to underperform assuming any of the excluded investments outperform the alternative investment option.

Positive Screens, ESG, and Engagement

While a number of studies have been performed evaluating the impact of positive screens, ESG, and engagement on investment performance, the data does not yet provide a compelling case either in favor of or against these types of approaches. Therefore we feel the potential for al-

pha generation related to positive screens, ESG and engagement still needs to be vetted through additional research.

While we believe that a responsible investing approach can be viable, issues that affect managers pursuing these strategies are similar to those faced by all investment managers in that adding value, net of fees, can be challenging. We believe that it is important to identify a distinct investment thesis for a manager that provides a high level of conviction in their ability to outperform in the future. Investors need to be diligent in their search for these managers and think creatively when it comes to identifying solutions.

WE BELIEVE THAT IT IS IMPORTANT TO IDENTIFY A DISTINCT INVESTMENT THESIS FOR A MANAGER

Investment Risk

Another common perception is that by going down the responsible investing path, an investment program is likely to be less diversified and more volatile. Studies in this area show that this is not necessarily the case[vi]. The integration of ESG factors into the investment process can lead to a reduction of negative company-level events that are more likely to occur if subpar ESG standards are in place. Diversification can work both ways, however, as a strategy that is particularly focused on a responsible investing initiative may in fact be more volatile because of the reduction in the universe of securities. Conversely, the excess returns of a more focused investment strategy might be less correlated to more traditional strategies and therefore help to diversify or reduce the overall risk of the program.

A number of the leading institutional investment programs have found it possible to implement responsible investing programs and still achieve competitive results relative to peers or benchmarks over longer periods. Many of these organizations have large asset pools and significant staff resources; however, there are also examples of smaller investment programs that have achieved success through a responsible investing approach.

Challenges

Even as the assets committed to responsible investing grow, there are still a number of challenges that investors face. One large obstacle is education. Many investment programs have not dedicated the necessary time and resources to understanding the opportunities and challenges associated with responsible investing. This lack of education can create misperceptions or a reluctance to implement these concepts. Education is also needed around the topic of responsible investing performance, volatility, etc., as many investors often dismiss the idea as involving negative screening that will detract value. Given these issues, some career risk or maverick risk certainly exists when it comes to responsible investing. Based on our experience with investors active in the responsible investing arena, it can be helpful to identify a champion for responsible investing, both within an organization's staff and its investment committee, to ensure that the subject is fully represented and does not become a "back burner" topic.

In addition to education, benchmarking and reporting are other areas that are still in the development stages. Individual company reporting on specific areas of environmental, social and governance metrics have improved and are a key area of focus in the U.S. and developed international markets. This remains a challenge, however, for some smaller or emerging market companies where reporting standards are less rigorous or staffing resources are limited. There are a number of research firms that can provide insight into the ESG metrics within companies. While these approaches are not perfect, given the limitations surrounding the data and the qualitative analysis required, they can be helpful in identifying the outliers (i.e. the companies that score very high or low).

Committees and investment staff should be aware that it remains a challenge to precisely account for the impact of responsible investments as some elements can be captured with numbers (energy saved, board diversification achieved, etc.) while other factors (such as quality of life) can be more challenging to quantify. Early adopters are quick to point out that it's important for investors to acknowledge that measuring the impact of responsible investing is a challenge and a precise measure of success may be difficult to identify.

As we touched on earlier, the universe of dedicated responsible investing strategies available to institutional investors is growing, but still somewhat limited. As a result, many strategies have relatively short track records and lower assets than what some institutional investors would consider as acceptable. Further, the fees associated with many responsible investing strategies, particularly mutual funds, are higher than industry averages. Because responsible investing strategies may focus on specific initiatives and therefore have a more narrow investment focus, a peer analysis of funds can be challenging. With a limited universe of disparate funds and strategies, it is harder to identify and compare investment managers. While databases maintained by the Social Investment Forum (SIF), Impactbase, and others provide a number of resources for responsible investors, the tracking of these strategies is still fragmented and in its infancy.

MANY INVESTMENT PROGRAMS HAVE NOT DEDICATED THE NECESSARY TIME AND RESOURCES TO UNDERSTANDING THE OPPORTUNITIES AND CHALLENGES ASSOCIATED WITH RESPONSIBLE INVESTING

Keys to Structuring and Implementing a Responsible Investment Program

As mentioned in the prior section, for those institutions interested in exploring responsible investing, it is critical to have the support of both the organization's staff and a committee member when attempting to advance the topic of responsible investing. Once the education process has been completed it becomes imperative to clearly define the goals, objectives, and benchmarks for evaluation of the program. If an organization's staff and investment committee are in agreement regarding the expectations and characteristics of the program, it is more likely to be successful.

While some investors have implemented responsible investing programs across their asset allocation, others have carved out small allocations such as 5% or 10% of assets to pursue the initiative. There is no right answer as to how much to allocate to specific responsible investing initiatives; rather, targets should be established based on the organization's mission and resources (e.g. staff, committee, consultant, etc.), as well as other factors (e.g. investment opportunities, fees, and return goals). Regardless of the size of the dedicated responsible investing allocation, the investments should be integrated into the return and risk profile of the overall program.

NEPC has long championed a risk-balanced approach to investing seeking broad diversification across return and risk factors. Accordingly, the analysis surrounding the implementation of a responsible investing program should be no different than any other investment. If an organization is making its initial foray into responsible investing we recommend starting with a public equity or debt strategy that will likely be easier for staff and the committee to understand and monitor. Alternative investments that have lower transparency and liquidity can create significant additional work for staff and committees. As it relates to responsible investing in alternative assets in general, the work is likely to be heightened given the limitations around sourcing, structures, track records, assets, etc.

Given the overall limitations of the manager universe, NEPC recommends that investors looking to integrate responsible investing criteria also engage current investment managers in a discussion around the role ESG plays in their respective approaches. Many managers may already be well along in the integration of ESG factors into their respective investment processes.

In short, the successful implementation of responsible investing is dependent on education, defining clear goals and objectives, and integrating responsible investing strategies into the total investment program. Further, NEPC recommends a risk-balanced approach to responsible investing and encourages investors to think outside the box when it comes to identifying these strategies.

Summary

Responsible investing has evolved significantly through the years. While early approaches to responsible investing were focused on negative screening, the focus has now moved to a much more broadly defined and active mandate. Responsible investing funds are now quite active through proxy voting, company engagement or pursuing public policy issues. Further, the invest-

ment options available have proliferated across virtually all types of investment strategies. Even strategies that are not officially branded as responsible investing approaches may actually be incorporating many ESG metrics into their respective approaches, which could further expand the opportunity set for investors.

Investors should analyze the potential impact that responsible investing could have on their investment program from both a return and risk perspective as different approaches will have varying impacts. Other challenges remain in the form of education, benchmarking and selecting investment strategies. Nevertheless, many organizations have found ways to overcome these hurdles to create responsible investment programs seeking

FOR THOSE INSTITUTIONS INTERESTED IN EXPLORING RESPONSIBLE INVESTING, IT IS CRITICAL TO HAVE THE SUPPORT OF BOTH THE ORGANIZATION'S STAFF AND A COMMITTEE MEMBER WHEN ATTEMPTING TO ADVANCE THE TOPIC OF RESPONSIBLE INVESTING.

to make a positive impact while achieving competitive returns. One potential opportunity for private foundations lies in the form of PRI (detailed further in the "In the spotlight: Program Related Investing" section).

At NEPC, working with investors to evaluate and implement responsible investing programs is one of the many ways we seek to help our clients. We engage with our clients to identify investment solutions that will help to meet investment return goals as well as the respective organizations objectives.

In the Spotlight: Program Related Investing

Over the last decade many institutional investment programs struggled to achieve long term investment goals as equity markets largely failed to deliver the level of returns experienced in prior years. As a result, many investors found that the value of their investment assets has eroded after the effects of inflation, potentially limiting the ability of their organization to achieve its mission. With NEPC and many other market participants forecasting subdued market returns over the intermediate term, investors once again find their programs in a difficult position as they try to resolve the following challenges:

- How do we achieve return goals and maintain our corpus?
- How do we increase the organization's impact?

For private foundations there is a solution that can help address these concerns. Program Related Investments (PRI) are typically below-market rate investments made by private foundations that qualify as a charitable expense under U.S. tax code. These types of investments must meet three important criteria:

- The primary purpose is the accomplishment of a charitable purpose;
- Neither the income generated nor the property appreciation is a driving force behind the investment; and,
- The funds cannot be allocated in any way to lobby for political purposes.

Private foundations, through their tax status, are required to make annual distributions equaling at least 5% of the respective foundation's investment assets. The distributions, typically in the form of grants, can make an incredible impact on the receiving organization; however, these distributions represent a 100% loss on investment for that portion of the foundation assets. PRI can help achieve the foundation's mission, but also retain some or all of the PRI assets and potentially earn a modest investment return as well. PRI can have multiple benefits for foundations because the investments can count towards the annual 5% spending rate, income produced from the investment is counted as investment income, and

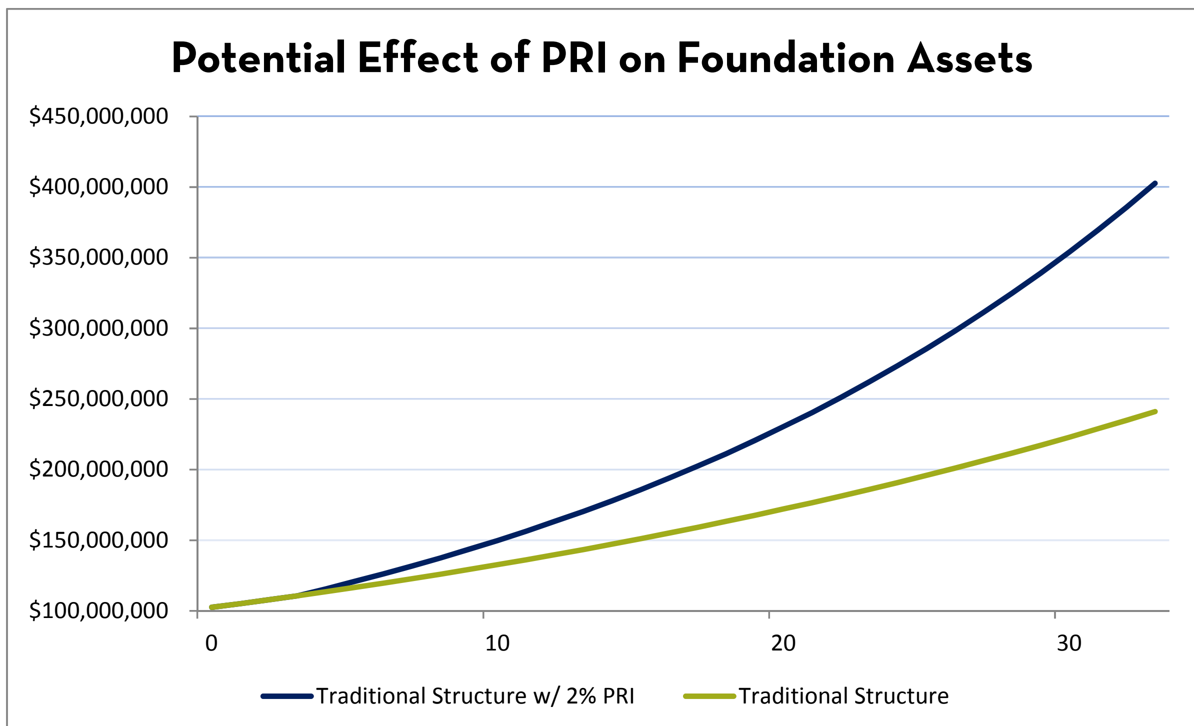
the organization's impact can still be significant. PRI present a very different opportunity to foundations than simply making grants each year.

The vast majority of PRI have been made as loans, but they can take many investment forms (e.g. real estate, private equity, etc.)[viii]. As mentioned above, PRI are typically below-market rate investments as they cannot be structured to maximize returns. If an investment does exceed expectations, however, its classification as a PRI does not change[ix].

The following chart illustrates the significant effect that PRI investments can have on an investment program's asset levels. In this example we highlight a private foundation that starts with $100 million in assets, earns an annual return of 7.5%, spends 5% annually and makes a 2% PRI commitment each year (blue line) which is paid back in full in year five. The green line represents a more traditional approach with no PRI where the growth in assets represents the 7.5% annual investment return minus 5% annual spending. Even with no incremental return assumptions for the PRIs, the foundation assets are significantly different as time goes on due to the retention of corpus and compounding of returns. We believe this represents a compelling opportunity for many private foundations especially in today's environment where return expectations remain subdued.

The major challenge with PRIs is that they are not easily sourced or structured, and therefore require additional time, resources, and, potentially, financial commitments (e.g. additional legal or advisory assistance) by the organization. Many smaller organizations looking to consider these types of investments should talk to larger institutions to gain insights into the process, structure and governance needed to participate in these types of investments. Additionally, foundations should take a close look at their current list of grant recipients as these organizations may be the best starting point for consideration as recipients of PRIs.

Exhibit 4



Source: NEPC, LLC

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Disclaimers and Disclosures

- Past performance is no guarantee of future results.
- All investments carry some level of risk. Diversification and other asset allocation techniques do not ensure profit or protect against losses.
- The information in this report has been obtained from sources NEPC believes to be reliable. While NEPC has exercised reasonable professional care in preparing this report, we cannot guarantee the accuracy of all source information contained within.
- This report contains summary information regarding the investment management approaches described herein but is not a complete description of the investment objectives, portfolio management and research that supports these approaches. This analysis does not constitute a recommendation to implement any of the aforementioned approaches.

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