FEW IMPLEMENT RESPONSIBLE INVESTING EVEN AS INTEREST GROWS: NEPC SURVEY

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Overview

Few Endowments and Foundations have implemented Responsible Investing initiatives, according to a survey by NEPC, LLC. In addition, these organizations expect Responsible Investing to comprise a small part of their investment programs even five years from now.

These low implementation rates are at odds with the increased interest in and greater awareness around this type of investing. At NEPC we see anecdotal evidence of the potentially bigger role Responsible Investing [1] may play in long-term portfolios. This may be fueled by a variety of factors, ranging from university endowments responding to student requests around fossil fuel investments, to religious orders promoting change through public policy engagement, and private foundations seeking creative ways to meet the annual 5% payout while maintaining their corpus.

To this end, NEPC, a market leader in Endowment and Foundation investment consulting, carried out a nationwide survey of a diverse group of Endowments and Foundations to learn more about their use of and interest in Responsible Investing (RI). Aside from the low implementation rate, the survey results show those that have implemented Responsible Investing primarily use positive or negative screening within their equity allocation, with most implementing it within 10% or less of their program. Most adopters have pursued market rates of return from their Responsible Investing program, indicating that performance expectation is not curbing this kind of investing. In addition there is little knowledge of Program Related Investing (PRI),[1] a potential solution for private foundations seeking to meet their annual 5% payout requirement.

These results lead us to believe there is an opportunity to spread awareness on the evolution of Responsible Investing and the myriad ways to implement it; and through this process help not-for-profit organizations further their missions.

WE SEE ANECDOTAL EVIDENCE OF THE POTENTIALLY BIGGER ROLE RESPONSIBLE INVESTING MAY PLAY IN LONG-TERM PORTFOLIOS

The Survey

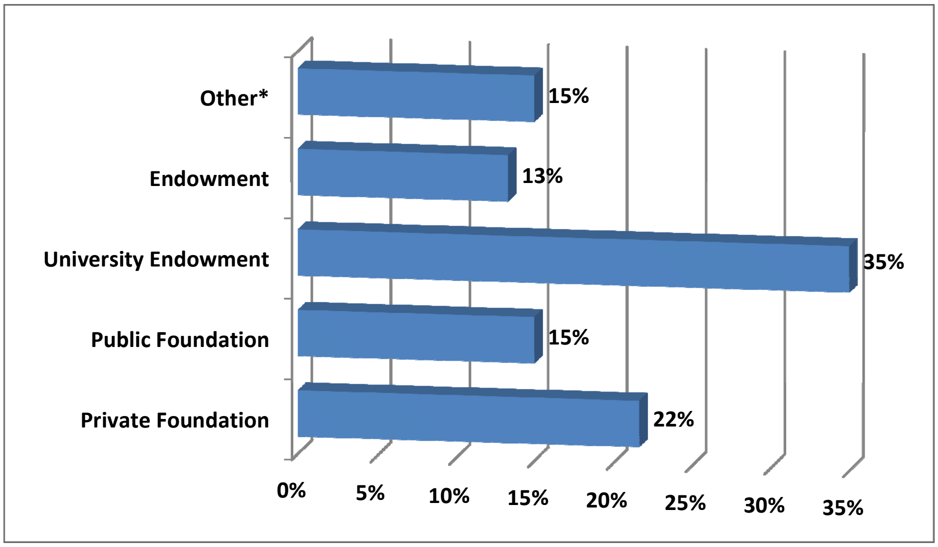
We surveyed a diverse group of Endowments and Foundations to understand their positions on Responsible Investing. The participants varied both by size and by organizational type. The highest concentration of survey respondents were university endowments (Exhibit 1). Over half of the respondents oversee assets between $101 million and $500 million (Exhibit 2).

Responsible Investing Isn't Just About Avoiding 'Sin' Stocks

Over the last several years, we have witnessed a growing awareness and desire among all types of investors to have a greater impact through their portfolio investments. Initially, faith-based institutions were early adopters of Responsible Investing. These institutions focused on negative screens, that is, deciding which companies or industries *not to* invest in due to their involvement

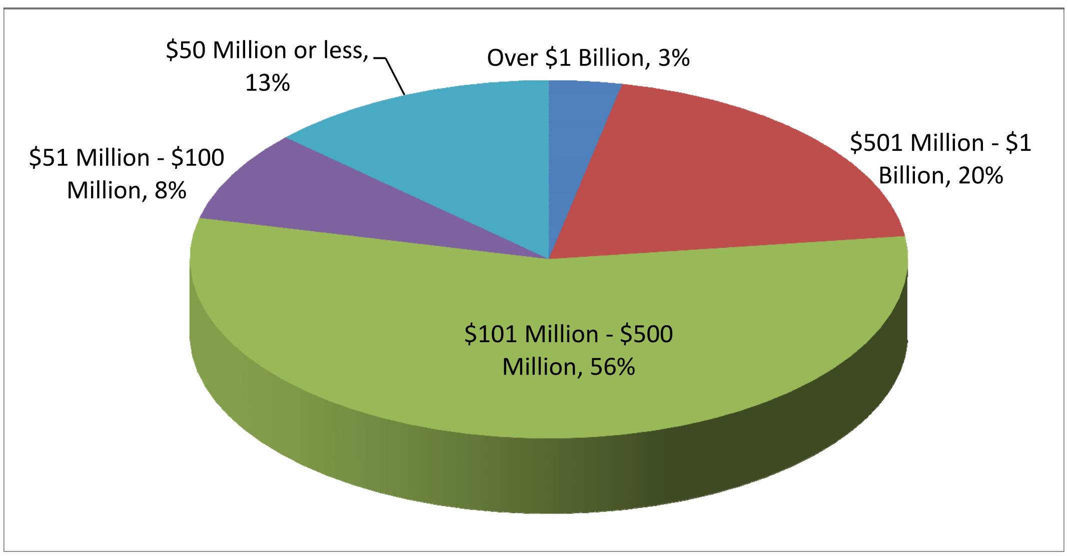
[1] For more information on Responsible Investing and Program Related Investing, please refer to NEPC's white paper, *Responsible Investing: Looking Back and Opportunities Ahead,* by Scott Perry, Partner (September, 2012).

Exhibit 1: Survey Participants by Type of Organization



* *Other includes multiple not for profits, 502(c)3 independent schools and community foundations*

Exhibit 2: Survey Participants by Size of Assets

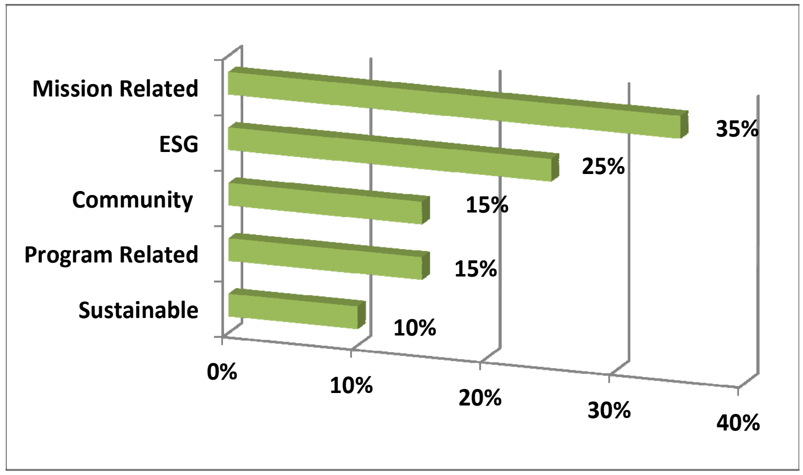


in an identified negative activity, for instance, gambling or alcohol.

At one time, Responsible Investing typically referred to negative screening. Today it is implemented more broadly and includes many subcategories. In addition to negative screening, Responsible Investing now includes proxy voting, active engagement with company management, or policy work. It exists in different guises: Environmental, Social and Governance Investing (ESG), Mission Related Investing (MRI), Sustainable Investing (SI), Community Investing (CI), and Program Related Investing (PRI). While only 20% of the survey's respondents stated they pursue Responsible Investing, we see growing interest in this topic as we field an increasing number of inquiries from our consulting clients. Mission Related Investing is the most active subsector of Responsible Investing, according to the survey results, with 35% of respondents who integrated Responsible Investing into their programs focusing on it. Environmental, Social and Governance Investing has also witnessed significant activity, at 25%. Respondents were less active in Program Related Investing—applicable to only private foundations—and Community Investing and Sustainable Investing (Exhibit 3).

Among those who implement Responsible Investing, nearly 60% have less than 10% of their program integrated into a Responsible Investment approach, while 21% integrate the approach throughout at least 50% of the investment program (Exhibit 4).

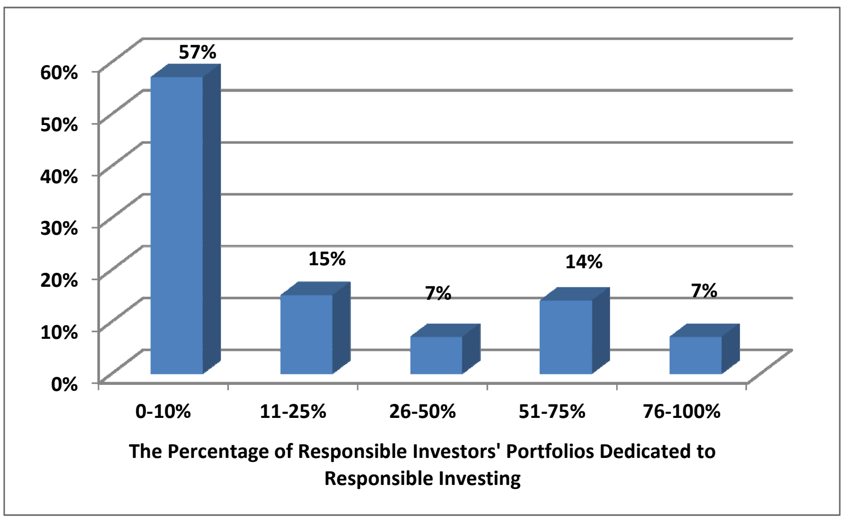
Exhibit 3: Concentration of Type of RI in Investment Programs



Implementing Responsible Investing

Nearly all respondents used either positive or negative screening even though there are a variety of ways to implement Responsible Investing. Positive screening, that is, investing to meet positive RI-based thresholds, was used by 47% of respondents. Negative screening, that is, investing in exclusionary screens, was used by 38% of respondents. Only 8% of respondents used Environmental, Social and Governance Investing, with potential involvement in proxy voting, company engagement and/or public policy work (Exhibit 5).

Exhibit 4: The Percentage of RI Integration in Investment Programs



Based on our research at NEPC, there are various Responsible Investing offerings in the form of public equity and fixed-income mutual funds. Larger investors can access separate accounts to achieve specific Responsible Investing goals and objectives. In addition, the market for Exchange Traded Funds (ETFs) continues to expand, providing avenues to address a variety of Responsible Investing goals. Private market offerings are also growing. Based on our review of the opportunity set, there are a significant number of private equity, infrastructure and real asset funds with some form of Responsible Investing in their mission statement. Additionally, many hedge funds now offer share classes that have negative screens in place. Among the survey respondents, the most popular way to implement Responsible Investing was through the equity allocation because it offers the most choices (Exhibit 6).

In our conversations with investment managers, it is clear that while many offerings are not marketed or branded as Responsible Investing strategies, investment managers are often incorporating Responsible Investing metrics into their investment process.

Exhibit 5: The Implementation of RI

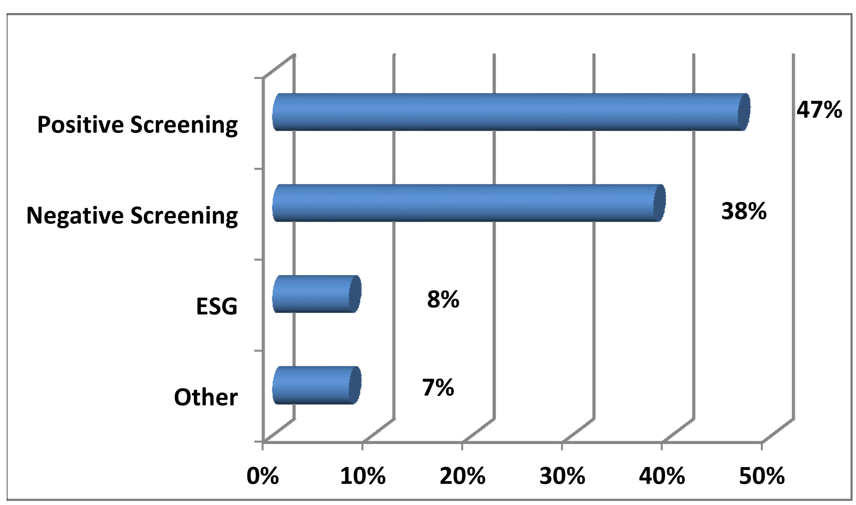
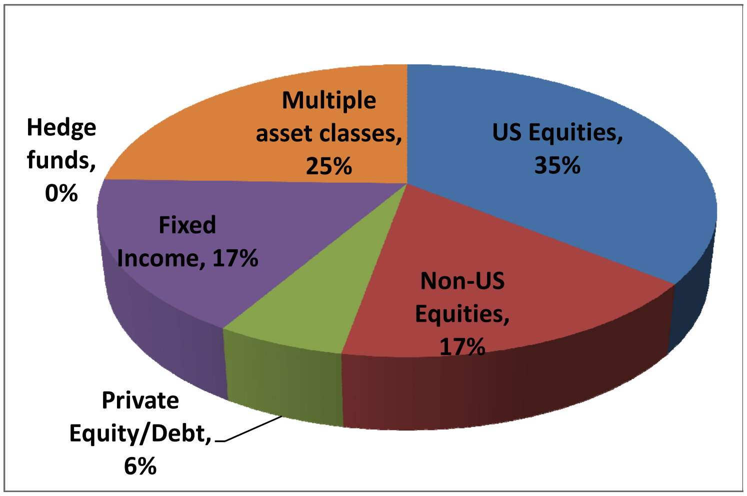


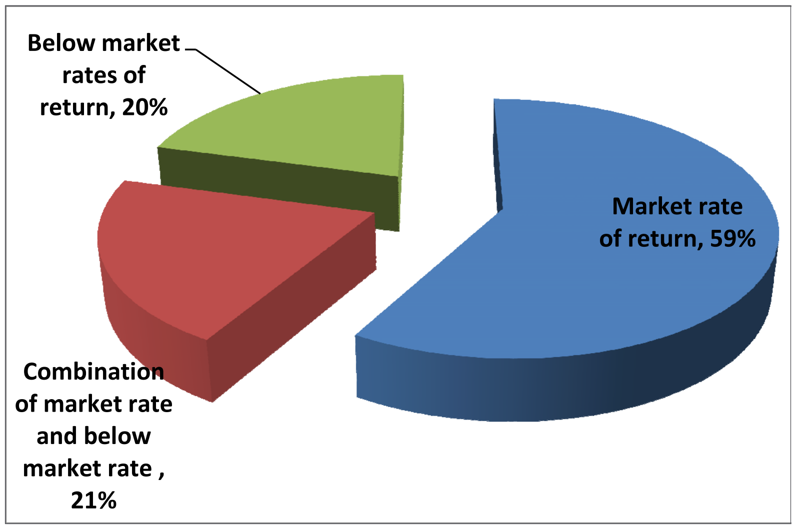
Exhibit 6: Break-up of RI Assets



The Impact of Responsible Investing on Investment Return

While some investors implementing Responsible Investing will settle for a lower-than-market return, 59% of the survey respondents expected to achieve a market rate of return; 21% anticipated a combination of market rate and below market rate of return; and only 20% expected a below market rate of return (Exhibit 7).

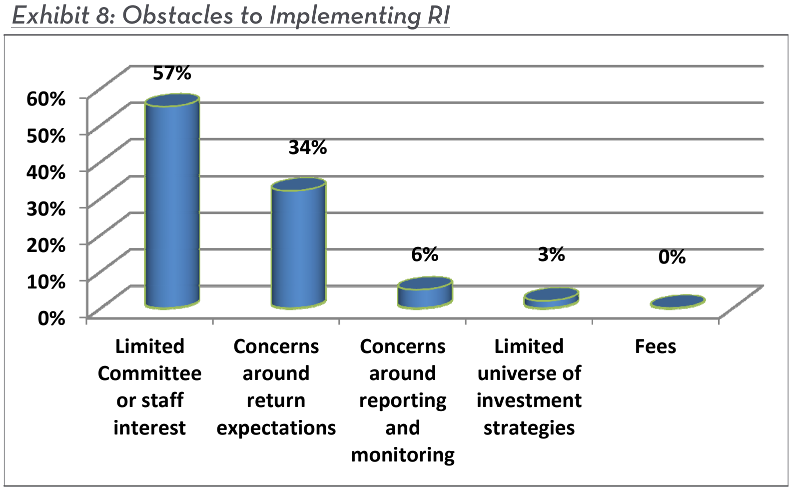
Exhibit 7: Return Expectations with RI



The Obstacles to Implementing Responsible Investing

Over 50% of the survey respondents were not integrating Responsible Investing into their investment programs because of limited interest from their committee or staff. Another 34% said concerns around performance expectations prevented them from implementing a Responsible Investing program. In addition, scarcity of time and full-time staff dedicated to investment programs may hinder the implementation of a Responsible Investing program (Exhibit 8).

Exhibit 8: Obstacles to Implementing RI



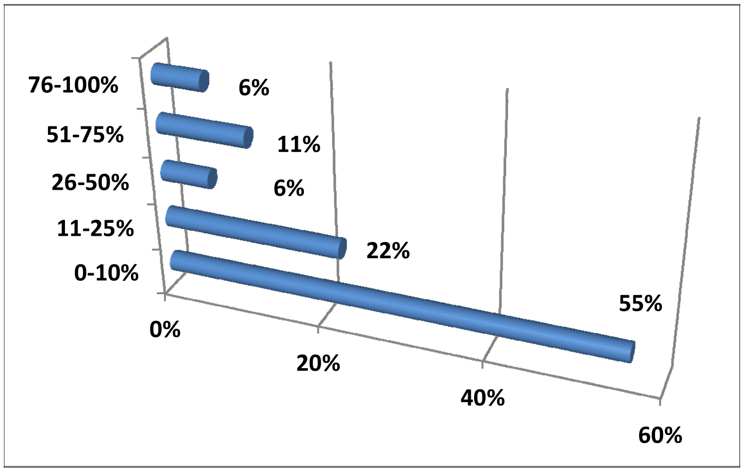
The Future of Responsible Investing

Survey participants who have implemented a Responsible Investing program or are considering one expected this approach to remain a relatively small part of their overall investments over the next five years. To this end, over half the respondents anticipated Responsible Investing to comprise 10% or less of their portfolios during the next five years; 23% expected it to be greater than 51%; and 6% anticipated it to be more than 76% (Exhibit 9).

Program Related Investing: A Viable Solution for Private Foundations

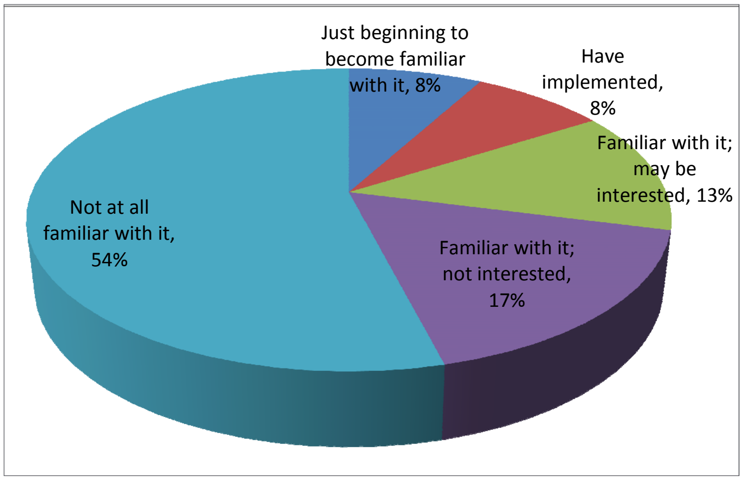
Private foundations may benefit from Program Related Investing (PRI), a type of Responsible Investing. PRI is a below-market rate investment that may--under certain circumstances--count toward the annual 5% of assets required to be distributed by the IRS. Income produced from the investment is counted as investment income, allowing the foundation to further its social mission. NEPC believes that PRI can be an innovative solution for many private foundations, given its potential to provide incremental investment returns on the 5% required distribution, and allow foundations to potentially retain the investment principal.[2]

Exhibit 9: The Percentage of the Fund Expected to be Dedicated to RI in the Next Five Years



Although there is limited knowledge of this alternative in the marketplace, we are seeing interest from foundations who are exploring this opportunity on their own and through select fund vehicles. Of the respondents who are affiliated with private foundations, 64% were either unfamiliar with PRI, or were just becoming acquainted with it; only 8% had implemented PRI (Exhibit 10).

Exhibit 10: PRI and Private Foundations



Conclusion

There is no one ideal way for investment programs to approach Responsible Investing. That said, the choices are expanding, allowing interested investors to exert greater influence on a variety of important causes and initiatives. Whether yours is a mission-driven, community-focused, or a social, environmental and governance oriented fund, there is a way to implement Responsible Investing initiatives. NEPC, a market leader in Endowment and Foundation investment consulting, is focused on uncovering the best solutions for our clients. Responsible Investing is just one of the areas where we research innovative strategies for our clients.

NEPC'S DEDICATED ENDOWMENT AND FOUNDATION PRACTICE WORKS WITH 94 CLIENTS AND REPRESENTS $48 BILLION IN ASSETS

Disclaimers and Disclosures

- 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.

[2] Be sure to talk to your tax advisor before implementing PRI to make certain you qualify under IRS guidelines.