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Governance process for evaluating sustainable investing

A guide for non-profit fiduciaries

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Sound governance is key to any well-run investment program. The “prudent man rule” embodied in the Uniform Prudent Management of Institutional Funds Act (UPMIFA), requires that fiduciaries act with care and diligence so as to avoid making investment decisions that result in undesired outcomes. This means not only that they must exercise good judgment in decision making, but also that they need to amass the relevant knowledge and skills essential to maintaining a sound decision-making process – one that aligns with their investment programs’ risk and return objectives.

This overarching governance principle applies to sustainable investing as well. Whether or not a non-profit investment fund and its fiduciaries decide to engage in sustainable investing, we encourage fiduciaries to adopt a proactive approach to addressing the rationale of the decision. Our goal with this paper is to provide a framework for addressing some of the governance-related issues in sustainable investing. The framework includes the following key steps:

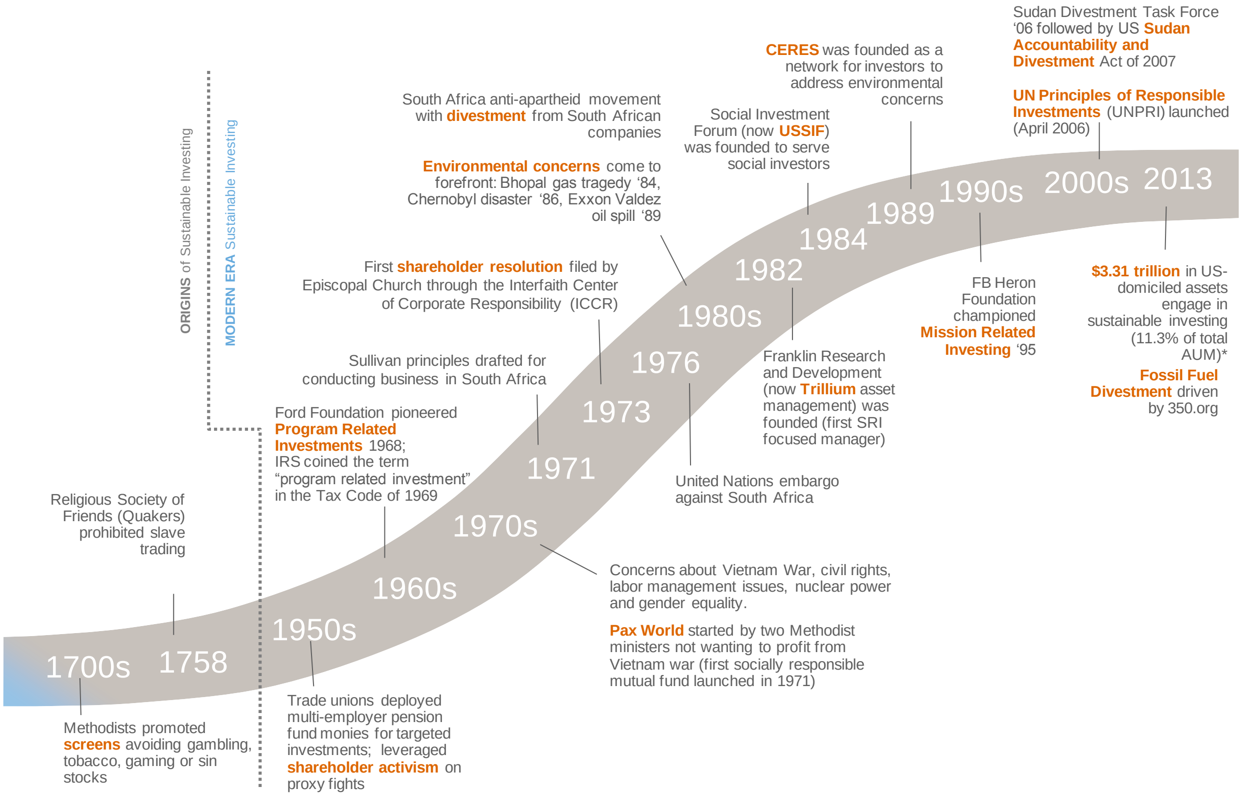
- Determining motivation: **Why** would the organization pursue sustainable investing, or why would it not?
- Defining objectives: **What** is the objective of pursuing sustainable investing?
- Identifying stakeholders: **Whose** opinions does the organization need to consider in determining whether there is to be a program, and its type?
- Considering potential **risks/costs**: potential impact, if any, on the overall investment program?
- Evaluating implementation considerations: **How** will the organization implement its sustainable investing program, should it decide to do so after completing the steps above? **When** should implementation occur?

Background: From SRI to ESG integration

While industry terminology continues to evolve, for the purposes of this discussion, we use the term "sustainable investing"[i] to encapsulate a broad spectrum of strategies that seek to capture both financial and non-financial returns – strategies such as screening (otherwise known as socially responsible investing, or SRI), impact investing, mission-related investing (MRI), shareholder engagement, ESG integration,[ii] etc. According to The Forum for Sustainable and Responsible Investment (USSIF), "What unites these diverse investment approaches – and what ultimately distinguishes them from the broader universe of assets under management – is the explicit incorporation of environmental, community, societal or governance issues into investment decision making, fund management or shareholder engagement activities[iii]."

The practice of restricting particular investments in portfolios has been around for many years, as can be seen in **Exhibit 1**, below. While some restrictions have remained constant from generation to generation, such as when faith-based institutions elect not to invest in "sin" stocks (e.g., alcohol, tobacco, pornography, etc.), other restrictions have been specific to their eras – for instance, anti-apartheid in the 1970s and 1980s, Sudan-free in the early 2000s, and, today, fossil fuel divestment. Historically, the practice of determining restrictions has often been in reaction to contemporary issues. A precedent of restrictive screening in the past doesn't necessarily imply a desire to do so going forward. There is increased fiduciary focus on governance best practices as well as on considering whether restricting a given set of investments may limit return opportunity (which is already challenged in today's environment).

Exhibit 1: Evolution of sustainable investing in the U.S.



*2012 Report on Sustainable and Responsible Investing Trends in the United States, produced by The Forum for Sustainable and Responsible Investment www.ussif.org

In other cases, pressure has led to evaluation of positive approaches that eschew restrictions in favor of incorporating various sustainable investing practices in funds. With the increased adoption of the United Nations Principles for Responsible Investment (UNPRI), institutional investors are now increasingly cognizant of how environmental, social and governance (ESG) issues can impact the long-term sustainable financial value of their investment programs. These principles and the ensuing compliance by UNPRI signatories have resulted in explicit incorporation of ESG considerations into investment analysis and decision making.

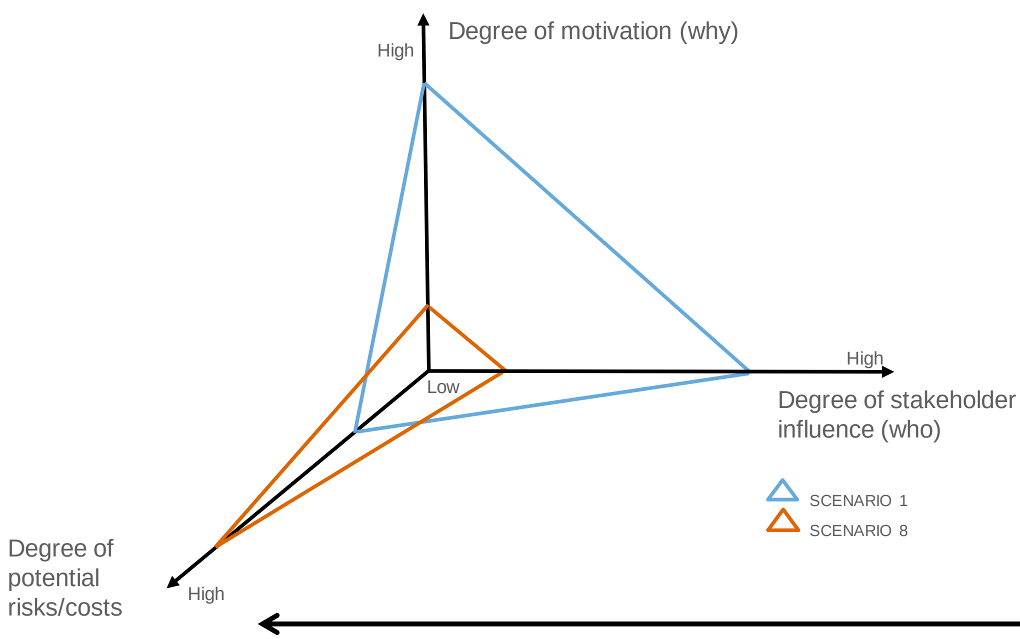
The various sustainable investing approaches can be viewed through a “values-based” versus a “value-based” lens, where “values-based” rationale is driven by investors’ unique beliefs (values) and “value-based” is the integration of ESG considerations within the standard financial framework, with the goal of positively impacting portfolio value. The former’s subjective nature may generate fiduciary debate around sustainable investing’s fundamental relevance to the success of the fund, and the level of fiduciary conviction around this issue often informs action.

Given the evolution of these practices, the related considerations around fiduciary duty and the potential impact on the investment program, we encourage non-profit investors to adopt a governance process for determining whether to incorporate a sustainable investment program. We encourage the fiduciaries of the portfolio, trustees, investment committee members, and staff to clearly articulate and document their organization’s beliefs with regard to the issues of sustainable investing.

Decision-making framework

As stated in the introduction, we have identified five key steps when considering sustainable investing; motivation (why), objectives (what), stakeholders (who), risks/costs and other considerations (how and when). We start by introducing a three-factor decision-making framework that tackles three steps in the governance process. As shown in **Exhibit 2**, the combination of three factors – degree of motivation, stakeholder influence and potential risks/costs – drives the decision to implement a sustainable investing program. We have identified a series of potential scenarios non-profits are apt to face in the decision-making process. For example, if the motivation to implement a sustainable program is high, and if the stakeholder support is high as well, it would be reasonable to consider a program – provided that the potential costs/risks are low or minimal, as in Scenario 1, as opposed to Scenario 8, where increased risk and higher implementation costs make the decision less practical or, in some cases, even impermissible, given the fiduciary duty of trustees. Determining where your organization is on this spectrum is an important step in this process. We address each of these factors in more detail in the following sections.

Exhibit 2: Three-factor decision-making framework



Higher Probability of Implementing Sustainable Investing

Lower Probability of Implementing Sustainable Investing

	SCENARIO 1	SCENARIO 2	SCENARIO 3	SCENARIO 4	SCENARIO 5	SCENARIO 6	SCENARIO 7	SCENARIO 8
Motivation	High	High	Low	High	Low	High	Low	Low
Stakeholder Influence	High	Low	High	High	High	Low	Low	Low
Potential Risks/Costs	Low	Low	Low	High	High	High	Low	High

Degree of motivation: Determining the "Why"

The first step is to ask the fundamental question: Why would your organization pursue sustainable investing? There are many reasons why non-profit organizations choose to implement a sustainable investing program. It is important to identify your own organization's reasons, in order to make informed decisions aligned with specific investment objectives. Working through a "beliefs exercise"[iv] with the fiduciaries can help better articulate the rationale.

Following are frequently cited reasons that drive a non-profit's rationale for incorporating a sustainable investing program:

- Wanting to align investments with the non-profit's mission.
- The board or the investment committee believes there are major societal issues that can and should be addressed through management of the investment program.
- The non-profit's values dictate it, i.e., "it is the right thing to do."
- Peers have implemented similar programs or are planning to do so.
- Desire to express organizational values through positive engagement.
- Desire to avoid negative press.
- Response to activist or stakeholder pressures.
- The investment committee views integrating ESG considerations as an investment risk-mitigation approach.

These reasons underlying the motivation for sustainable investing can be categorized under the "values-based" or "value-based" approaches discussed earlier, with some falling in both.

Degree of stakeholder influence: Identifying the "Who"

Closely aligned with "why" is "who." Whose views should be considered, and who has influence over the determination of whether or not to incorporate a sustainable investment program? For instance, with an educational institution, there is a wide array of constituents whose voices may be strong and influential, including faculty, students, and alumni and other potential donors (i.e., parents, grantors); for foundations, the constituents may include the grantors or external donors to non-private foundations; hospitals may face similar pressures. Understanding the views of these stakeholders and carefully navigating the potential differences of opinion is crucial; having a well-documented governance process and clearly articulated beliefs derived from deliberating the "why" can help in addressing varying constituent views. Ultimately, fiduciary decisions must be framed with the goal of the non-profit's investment program kept front of mind.

Degree of potential risks/costs

In addition to the "why" and "who" considerations we have summarized above, consideration of risks and/or costs are critical. In evaluating the risks/costs you should recognize that there could be risks/costs to implementing a program as well as not implementing one. Some of the risks/costs that need to be evaluated include:

- Does the size of the portfolio limit the ability to implement, or would it result in additional implementation costs? For example, if commingled funds are currently being utilized, what is the potential feasibility/cost of implementing sustainable investing?
- What are the potential impacts of integrating sustainable investing on portfolio performance, monitoring and management?
- What are the costs of such a program, both financial and non-financial?
- What are the risks of incorporating/not incorporating a sustainable investing program; e.g., reputational risk?
- What are the resource requirements for implementing a sustainable investing program?

- Who should be educated, and what form will this education take? For instance, informing student activism groups as to the potential impact of sustainable investing on the endowment, or informing the board of a foundation as to the pros and cons of implementing a mission-aligned investment program.

Sustainable investing objectives: Defining the “what”

The three-factor decision making framework helps clarify whether there is a high probability or low probability of implementing a sustainable investing program. Having addressed those questions will help define the “what”: what is the objective of pursuing sustainable investing? In explaining your deliberations vis à vis objectives, you may simply need to show that you have considered sustainable investing options but have chosen not to change the investment program in any way, as in Scenarios 8 in Exhibit 2 where there is low motivation and stakeholder influence and high potential risks/costs. At the other end of the spectrum, you may choose to implement a program across the total portfolio. There are numerous ways to pursue sustainable investing, with different levels of complexity and time commitment. Before traveling too far down any one path, fiduciaries must be clear on what the objective is and what “a sustainable investing program” means – for instance, is it to be a broad program integrated across the fund’s total portfolio, screening a certain category of investments, or will it involve investing a segment of the portfolio in a thematic investment strategy (e.g., clean water, renewable energy)? This step in the process entails understanding the multitude of sustainable investment *approaches* and determining the ones that align best with the motivations discussed above. Some of the common investment approaches are: screening, shareholder engagement, ESG integration and positive/impact investing.[v]

Other important considerations at this stage are determining the *alignment* of the approaches with the mission of the organization as well as the overall *risk and return objectives* of the investment program. Importantly, the answer to “what” may be that the objective of the investment fund is purely to achieve the best return for a commensurate level of risk. The fiduciaries may, or may not, believe that no form of investment constraints to addressing non-financial goals should be imposed on the fund. Clearly documenting this view in the decision-making process is paramount in efforts to avoid alienating certain constituent groups and/or individuals.

Other questions to consider at this stage are:

- Are you considering integrating sustainable investing across the entire portfolio, versus a segment of the portfolio?
- Are there certain asset classes you would like to approach selectively, or are you considering implementation across all asset classes? How might either approach alter the investable opportunity set?
- Are there certain thematic approaches you would like to pursue? (These may include climate change, health care, microfinance, etc., that may align with the values of the organization).
- Are you keen to engage in direct shareholder engagement, or to pursue proxy voting via your investment provider?

Implementation considerations: Evaluating the “how” and “when”

As in the previous stages, there are many options available under the “how” and “when” stage. The organization’s *expertise* in sustainable investing, availability of *resources* required to implement a program, and the timing of implementation, are all important considerations at this stage of the process. Implementation can take time, and we have recently seen institutions being caught unprepared for stakeholder demand for immediate action. Proper documentation addressing the issue may help fiduciaries gain the necessary time.

Some other actions that may be considered (but which go beyond the scope of this paper) include:

- Updating your investment policy statement as to your motivations, beliefs and objectives for including or not including a sustainable investing program. The need to document the policies and the rationale is important.

- Writing a separate "Investor Responsibility" document, also known as a Policy for Sustainable Investment.
- Forming a separate subcommittee of the board or investment committee that can liaise with your investment provider.
- Engaging in regular education on current trends via your investment provider and/or industry conferences. An annual update to your investment committee and board may be beneficial.
- Asking your vendors what they are doing to engage in sustainable Investing. Perhaps they are signatories of the UNPRI, which requires of them a certain level of participation and compliance with the principles, which could satisfy your requirements.
- Becoming an UNPRI signatory[vi] or member of an industry group focused on sustainable investing issues.

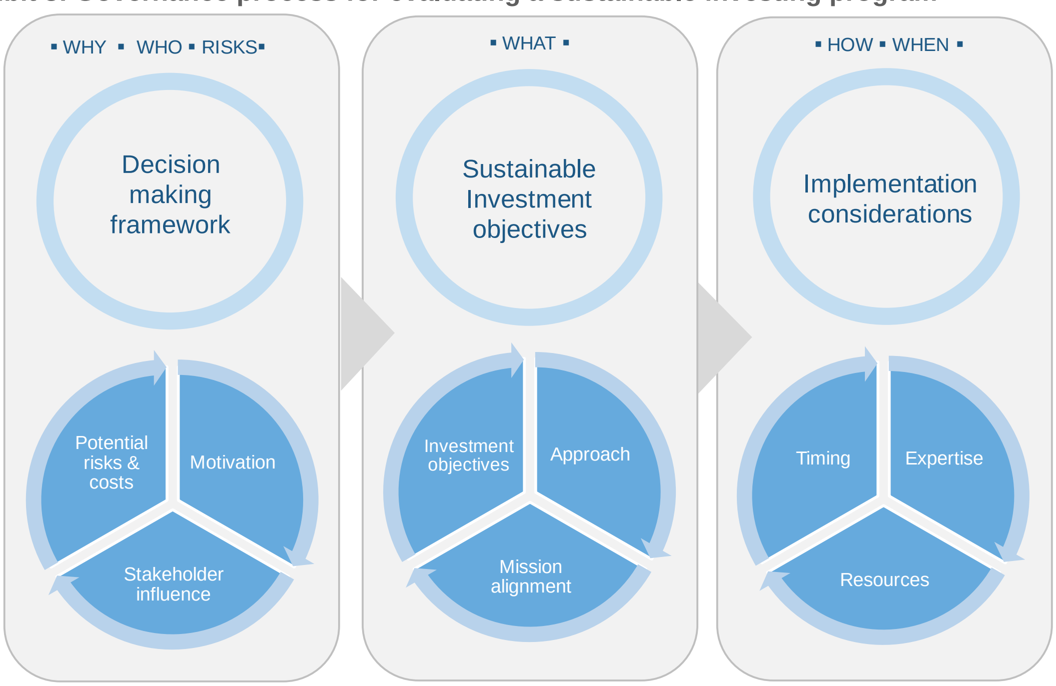
The decision also could have implications for various aspects of your investment program's oversight, such as modifications to your approach to asset allocation, portfolio construction, manager selection and/or implementation vehicles.

Governance framework: Bringing it all together

Exhibit 3, below, is a governance framework that encapsulates the considerations for evaluating a sustainable investing program, as discussed in this paper. To summarize, it is important to:

- Pursue a three-factor decision-making framework that takes into account motivation ("why"), stakeholder influence ("who") and the potential impact (risks and costs) of a sustainable investing program.
- If the decision is to move forward, the next step will be to identify the objectives ("what") of implementing a sustainable investing program: your explicit investment objectives, the program's alignment with the non-profit's mission and the multiple approaches that might be utilized.
- Finally, addressing implementation issues ("how"), such as those concerning the required expertise and resources, and the timing of implementation ("when"), are important. Documenting all of the considerations discussed herein, in the form of a sustainable investment policy is essential as well.

Exhibit 3: Governance process for evaluating a sustainable investing program



Conclusion

Whether or not to incorporate sustainable investing in your organization's investment program is an important matter to address – and it has important governance implications. Having an established governance structure is essential in many respects. We encourage organizations to pro-actively review their program and ensure that there is structure in place for responding to and evaluating all issues surrounding this topic; a past decision may not be a precedent (for example, agreeing to be "Sudan-free" does not implicitly mean that you are choosing to divest from fossil fuels). Given the complex environment that non-profit fiduciaries are navigating and the considerations needed to satisfy fiduciary duty, clearly and explicitly articulating the "why" supplemented by other facets of the governance process discussed herein is a beneficial approach to evaluate sustainable investing.

[i] Other terms are "responsible investing" and "sustainable and responsible investing." None of these terms adequately capture the diversity of approaches to evaluating values-based and value-based environmental, social and governance criteria in investment decision making. For the purposes of this paper, we are using the umbrella term "sustainable investing" to encapsulate all of above.

[ii] For further detail on approaches, see M. Kathuria and S. Murray (July 2013): "Mission-Related Investing: How non-profits use investments to further their mission," *Russell Investments*.

[iii] Fundamentals of Sustainable and Responsible Investing, USSIF, May 2013

[iv] See Kevin Turner's "Are your actions consistent with your beliefs?" Second quarter 2012 Russell *Communiqué*.

[v] For further detail on approaches, see Kathuria, M. and S. Murray (July 2013): "Mission-related investing: How non-profits use investments to further their mission," Russell Investments research.

[vi] Russell Investments has been a signatory to UNPRI since 2009. A list of all signatories and their publicly available reports can be found at UNRPI's website. http://www.unpri.org/signatories/signatories/ .

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