

## Socially Responsible Investing

### Aligning your institution's investments with your organizational values

The origins of socially responsible investing (SRI) in this country date all the way back to the mid-1800s, when certain religious organizations chose to eschew any investments that would support the ongoing slave trade in the South. This practice of excluding various investments on moral grounds continued over the ensuing decades, but for the most part as an individual, organizationally-driven mandate. It wasn't until the 1920s that The Pioneer Fund became the first investment vehicle to formalize a "sin tax" approach to SRI – screening out any investments in alcohol, tobacco or gambling organizations.

During the 1960s, 1970s and 1980s, the concept of SRI continued to evolve, embracing emerging social concerns such as civil rights and apartheid, along with mounting concerns over environmental issues which firmly took center stage as the new millennium began. Most recently, a large consortium of philanthropic organizations, endowments, institutions (spearheaded by the Rockefeller Foundation), cities and wealthy individuals announced the divestment of \$50 billion away from the fossil fuel industry, as part of a renewed commitment to fight climate change.

But while SRI gains increasing interest among a widening circle of organizations, it remains a somewhat slippery slope to navigate.

### SRI or ESG? The choice depends on your motivation

At SunTrust Foundations and Endowments Specialty Practice, clients often approach us to discuss their organization's desire to pursue a course of "responsible investing." But there are various approaches and a multitude of nuances that will be driven by the institution's underlying motivation. SRI mandates, by their nature, reflect a prescribed organizational morality or a desire to create social change. Typically these are exclusionary – using investment screens and ethical criteria to eliminate particular industries or securities that are contrary to the core mission or beliefs of the group. Less common are inclusionary SRI mandates, which rather than seeking to prohibit certain activities or behaviors, strive to incent favored ones through targeted investment (e.g., a heavy portfolio weighting in alternative energy providers).

Unlike SRI, which carries an implied weight of obligation, environmental, social and governance (ESG) factors are born out of economics rather than ethics. At its core, the underlying goal of ESG investing is essentially to integrate environmental, social and governance considerations along with other factors when determining a particular investment's suitability for portfolio inclusion. ESG factors can run the gamut from assessing a company's carbon footprint to the creation of products or the delivery of services that have the potential to meet an emerging social need.

### Where do you draw the line?

For most clients, the greatest SRI-related challenge comes in deciding just how far they wish to pursue their social mandate. How do you decide what investments to restrict or proactively invest in? And more importantly, how rigorous do you wish to be in pursuing this mandate?

On the asset allocation front, which must be clearly articulated in your Investment Policy Statement, you need to specify precisely what asset classes and securities will or will not be allowed. For example, suppose that you've decide to divest of all fossil fuel investments. Does this mean you'll solely focus on supply side divestment, eliminating all investments in any

### Emerging Trends: Impact Investing

Investments made into companies, organizations, and funds with the goal of generating social and environmental impact alongside a financial return. The growing impact investment market provides capital to support solutions to the world's most pressing challenges in sectors such as sustainable agriculture, affordable housing, affordable and accessible healthcare, clean technology and microfinance.

## 5 Essential Manager Due Diligence Questions

1. Please explain the steps you undertake to integrate financially impactful SRI issues into your investment process?
2. Can you cite some specific examples of client SRI mandates and how you've incorporated those into their portfolio design?
3. Would you please explain your process for monitoring SRI risks across your portfolios on an ongoing basis?
4. Is your firm a signatory to the U.N.'s Principals for Responsible Investment (<http://www.unpri.org/signatories/signatories>)?
5. Could you describe your approach to communicating with clients regarding SRI-related portfolio management issues or concerns?

### Emerging Trends: Program-Related Investments

As foundations and corporate funders search for new ways to extend their assets and increase the impact of their programs, many are offering traditional financing such as loans, loan guarantees and linked deposits to better leverage their limited dollars in promoting community wealth building and other mission-related foundation goals.

integrated oil companies or coal producers? What about the demand side? Does your social passion about the issue also extend to prohibiting investments in any companies that are excessive consumers of fossil fuels? If so, it becomes a mandate with a much more far-reaching impact on your organization's portfolio. Perhaps it will preclude you from investing in wide swath of blue chip stocks like McDonald's, Walmart or FedEx as a result of their massive fossil fuel consumption.

The answers to these theoretical questions will then need to be translated into documented tactical processes that will govern how potential managers will be selected, how they will screen for the SRI criteria you have established, how you will monitor their continued adherence to the mandate, and how your organization will convey any future changes to the mandate when and if they occur. It's very easy for most managers to work within the restraints of common SRI mandates (e.g., Catholic charities) that have very specific criteria. If, however, your SRI directive is highly customized, you'll want to carefully review the trackrecord of potential managers in working under similar mandates.

It's these types of questions and considerations that trustees, executives and stakeholders will all need to grapple with in order to build the engine of your organization's SRI strategy.

### A three-dimensional tradeoff

It's important to understand that there will be tradeoffs on risk and return, depending on how deep and how far along the SRI and ESG continuum your organization wishes to go, particularly as they relate to broader and more thematic ideas. It's one thing for an entity to say "we don't want to own tobacco or alcohol in our portfolio." Those prohibitions represent a tiny segment of the investment universe and can be eliminated without any meaningful tradeoff of risk and return within the portfolio. When you start getting into thematics, such as the fossil fuel example elucidated previously, depending on how far and deep your organization wishes to go, you could end up with radically different return and risk characteristics of your investment portfolio.

We all would love the proverbial "free lunch" - eliminating those portfolio components that we find morally, ethically or socially repugnant, without having to sacrifice returns or assume increased risk. But, there is generally an implied tradeoff in the way of diminished portfolio returns that comes with the introduction of an SRI mandate. And typically, the extent of the downward pressure on performance is directly correlated to the scope of the mandate. As the mandate becomes more far-reaching, the potential universe of investments shrinks, portfolio diversity may suffer and the efficient frontier may be pushed out, causing the organization to potentially take on additional risk to achieve the same historical returns or sacrifice return to maintain the portfolio's risk profile.

Firms like SunTrust can provide you with a framework to assist in your decisionmaking process, but ultimately your organization will need to determine how important it is to eliminate the targeted companies, industries or themes, as it may significantly impact the risk and return profile of your portfolio.

### Getting started

Most institutions will initially form a working group to explore both the advisability and feasibility of establishing an SRI or ESG mandate for their organization. Often times, that working group will also include stakeholders from the broader community and an external advisor like SunTrust who can bring a depth of SRI expertise and help model the impact of potential strategies on portfolio risk and return.

# A 4-step approach to SRI implementation

## 1. Determine your strategic goals

There are no hard and fast rules for implementing a socially responsible investing policy. Most investors typically begin with a relatively simple implementable approach, and over time refine and evolve it into a more robust strategy. The following are three common approaches that are often used to initiate an SRI policy:

- a. **Negative screening** – the process of excluding investments in certain companies or sectors based on predetermined criteria. For mission or values based investors, this can be an important way of addressing particular ethical issues and avoiding risks to their reputations. For example, a policy may exclude investment in sin stocks (e.g., tobacco, firearms, gambling, liquor, etc.) or perhaps prohibit environmentally harmful investments (e.g., fossil fuel producers, chemical companies, paper mills, etc.).
- b. **Positive screening** – involves investing in companies with a commitment to responsible business practices, that produce positive products and services or that address environmental or social challenges. Positive screens can be established to identify companies that sell positive products (e.g., food, clothing, water, housing, etc.), to promote certain investment themes (e.g., environmental technology), or as a “best of sector” approach that allows you to maintain your current sector allocation balance while favoring those firms with the best ESG practices among their peers.
- c. **Shareholder engagement** – this approach seeks to positively impact the ESG policies and practices of companies through proxy voting, shareholder resolutions, collaborative and/or direct engagement conducted privately or publicly. While smaller organizations may find it difficult to individually influence companies they choose to invest in, they can select investment managers who will undertake these practices on their behalf.

## 2. Document your policy framework

Carefully documenting how the SRI policy will be implemented will ensure there are clear guardrails in place when integrating your organization’s SRI considerations into the investment process. But it’s important to remember that these guidelines must be achievable within the practical constraints of the investment markets. Ideally, measurable benchmarks should be established so that results and adherence to the policy can be properly monitored.

## 3. Manage the implementation

Once you’ve established your mission and aims and articulated your socially responsible investment policy, you’ll need to consider both the size of your investment portfolio as well as the organizational resources available to implement and manage your SRI policy. Most organizations choose an incremental approach to implementation that’s sequenced over time, in order to more thoughtfully address issues and questions as they arise. But at a minimum, you’ll initially want to:

- a. Seek advice from a knowledgeable and experienced outside partner like SunTrust
- b. Audit your existing portfolio to determine which holdings will be retained, and which do not fit within the mandate of the new SRI policy
- c. Develop a plan and timetable to divest from those investments that don’t fit with the policy and look for suitable replacements (e.g., an ESG mutual fund)
- d. Ensure that existing investment managers (as well as your manager selection process) are able to meet your organization’s SRI policy

## 4. Monitor and modify post-implementation

You’ll want to periodically monitor investment manager adherence to the principles set down in the SRI strategy. Quarterly reports from investment managers should include not only financial performance, but also updates on adherence to the SRI policy, any policy breaches, actions taken to resolve the breaches and copies of their voting records with regard to proxies and shareholder resolutions.

## **Emerging Trends:** Shareholder Advocacy

Along with corporate engagement, advocacy (through direct dialogue, shareholder resolutions and proxy voting) is becoming an increasingly important means by which investors can positively influence corporate behavior to enhance long-term shareholder value and sustainability.

When and if a decision is made to pursue a responsible investing approach, you'll need to create a detailed implementation strategy. Clearly articulating your organization's SRI mandate as part of your investment policy statement is merely the tip of the iceberg. You'll also need to document all of the various processes and procedures that will be needed to realize your SRI vision, along with the associated roles and responsibilities.

For example, an exclusion-based approach will require ongoing oversight of the exclusion list, along with a methodology to translate the list into actual portfolios with minimal impact to risk or return. You'll also want to document your organization's due diligence policies as relate to selecting, monitoring and changing investment managers. Strong documentation is especially critical with SRI given the emotionally charged nature of the topic. Whatever course of action you pursue, you can expect to be challenged by those who are philosophically opposed or who would have preferred a different course of action.

## **Conclusion**

Your organization's mission, investment policy, and constituency needs and behaviors will help determine how you communicate any SRI mandates or related issues, both internally and externally. Inevitably, however, some stakeholders may view the introduction of an SRI mandate as a luxury, an unnecessary distraction, or even an unacceptable investment risk.

Theoretically, socially responsible investing doesn't have to be an all-or-nothing decision. A sliding scale of engagement can be pursued by institutions that are unsure but interested in exploring the concept. But at SunTrust, we strongly advise our clients to either fully-engage or disengage quickly. If your organization is passionate about a certain SRI mandate, then embrace it as fully and reasonably as you can. Otherwise, your efforts will merely result in stakeholder confusion and lingering questions as to whether your efforts are yielding any benefits.

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<sup>1</sup> As of September 30, 2016

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