

The value of environmental, social and governance factors for foundation investments



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Executive Summary

The recent financial crisis exposed the risks that all investors, including trusts and foundations are exposed to. Any investor with a stake in the financial market has a stake in ensuring that a similar crisis is avoided in future.

The crisis highlighted the significance of accountability, transparency, the consideration of 'extra-financial' research in investment processes, responsible ownership and long-term investing. Increasingly it is recognised that these values should be at the heart of the investment strategy of trusts and foundations.

The consideration of 'extra-financial' factors, such as environment, social and governance (ESG) issues in investments is nothing new. A number of charities have been doing this for decades. Organisations such as the Joseph Rowntree Charitable Trust have invested in line with their charitable objectives without losing out financially. Whether or not you agree with the mission case for incorporating ESG factors, there is growing evidence that this is an astute financial decision and can be used to safeguard and enhance returns. It can help to mitigate risks and take advantage of opportunities. The United Nations Environment Programme Finance Initiative (UNEP FI) produced a comprehensive study into this issue which found that 'ESG issues are material – there is robust evidence that ESG issues affect shareholder value in both the short and long term.'¹

Addressing material ESG risks and opportunities is allowed under Charity Commission guidance and has a clear fit with the duties of trustees. A failure to do so is seen by some as a breach of fiduciary duty.²

The most financially-relevant ESG factors can arise from the actions and reactions of regulators, consumers, suppliers, employees and financial markets. Two issues which are seen as crucial to ensuring sustainable financial returns and which therefore cannot be ignored are governance and climate change.

Poor corporate governance has been shown to have serious consequences for individual companies and the wider economy. The way a company manages risk should be of particular concern to investors. Corporate governance is increasingly considered as a means of enhancing the long-term performance of investments. In 2008 the ABI (Association of British Insurers) published research showing that companies with the best corporate governance records produced returns 18% higher than those with poor governance.³

There is a growing consensus that climate change will be financially significant to all companies. It presents a systemic risk and the Stern Review⁴ clarifies the threats posed to the economy and the financial impact of not addressing climate change. Factors such as regulation, licence to operate, the price of energy and waste disposal, changing weather patterns and the impact on resources, reputational issues and the potential for future lawsuits indicate the financial relevance of climate change for investors. A range of mainstream investors, including public pension funds, have pioneered strategies for ESG integration, while signatories to the United Nations Principles for Responsible Investment (UN PRI) now represent \$18 trillion, an indication of the growing recognition of ESG integration as a value driver.

¹ UNEP Finance Initiative Asset Management Working Group (2006) 'Show Me The Money: Linking Environmental, Social and Governance Issues to Company Value'.

² See Freshfields Bruckhaus Deringer (2005) 'A Legal Framework for the Integration of Environmental, Social and Governance Issues into Institutional Investment' (UNEP Finance Initiative).

³ ABI (2008) 'Governance And Performance In Corporate Britain'.

⁴ Stern, N. (2006) *Stern Review: The Economics of Climate Change*.

As asset owners investing for the long term, trusts and foundations should take advantage of the skills, expertise and techniques developed by other asset owners for ESG integration. There are a number of ways to go about it:

- 1** Agree your position on responsible investment
- 2** Research your investment manager's expertise and practice in ESG integration
- 3** Include ESG integration in your investment mandate
- 4** Join collaborative initiatives, such as the Carbon Disclosure Project
- 5** Vote your shares on ESG related issues
- 6** Engage with companies directly or via investment managers
- 7** Invest in sustainability-themed funds such as greentech, microfinance or timber
- 8** Invest in responsible investment funds that use ESG integration

The integration of ESG factors into investment processes is now recognised by the mainstream as a way to enhance value. Given their financial relevance, there is a danger that by not taking ESG issues into account trusts and foundations could be seen as acting imprudently and failing to secure their long term financial sustainability. To safeguard assets for future beneficiaries, trusts and foundations now have the opportunity to ensure their investments are managed to mitigate ESG risks and take advantage of ESG opportunities. It is not enough to assume that this is being taken care of. Acting as responsible owners, trusts and foundations should question and encourage their asset managers to adopt and implement best practice in responsible investment.

1 Introduction

The investment sector is increasingly looking at how environmental, social and governance (ESG) factors can pose financial risks to investments. It has been argued that a greater focus on social issues could have helped to identify the sub-prime crisis and that a greater emphasis on governance issues could have drawn attention to how banks were managing risks.⁵

The credit crunch has exposed the risks that financial institutions - and investors – were taking. With a carbon crunch now looming, trusts and foundations could be exposed to even greater risks. In fact the UK Government's chief scientist has warned that the world is facing a crisis to match the current one in the banking sector. Professor John Beddington has stated that the growing world population will cause a 'perfect storm' of food, energy and water shortages by 2030, and the situation will be exacerbated by climate change in unpredictable ways.⁶

But just as investment products have evolved to provide opportunities to diversify, minimise risks and take advantage of changing market conditions, so methods have evolved to address ESG risks and opportunities.

To take advantage of responsible investment practices trustees should review how they appoint and work with asset managers. The consideration of ESG factors to safeguard or enhance financial performance is clearly permissible under fiduciary duty. To ensure that asset managers are incorporating a responsible investment approach trustees should review their contractual arrangements.

This paper examines:

- The current context for trust and foundation investments
- How responsible investment fits with fiduciary duty
- Evidence on the impact of ESG factors on financial performance
- Examples of ESG issues and why they are financially relevant
- Details of the responsible investment approaches used by other asset owners
- Suggested actions for your organisation

This paper was put together by the EIRIS Foundation's Charity Project. It is based upon a series of interviews with responsible investment experts and a review of recent research and reports. Our aim is to provide trusts and foundations with the latest information on why ESG factors are relevant for all investors and guidance on the first practical steps to take.

We use the term responsible investment to refer to the incorporation of environmental, social and governance issues into investment decisions and ownership. This can include socially responsible investment (SRI) which may also involve a focus on aligning investments with mission.

⁵ The example of the Interfaith Center on Corporate Responsibility's warnings on predatory mortgage lending practices is quoted in Kropp, R (5 December 2008) Shareowner Advocates Find Hope Despite Troubled Economic Times in www.socialfunds.com

⁶ McGourty, C. (19 March 2009) 'Global crisis "to strike by 2030" BBC News

2 The Investment Context

The US sub-prime lending crisis, the subsequent credit crunch and global downturn has had dire consequences for investors. Trusts and foundations have lost sizeable chunks of their endowments which will impact grant recipients. Whilst it is a very difficult time for the charity sector, it is also a time to ensure that resources are managed and used effectively, and to reflect on what led us to the current situation. Anyone with a stake in the financial market has a stake in ensuring that a similar situation is avoided in future.

The Association of Chartered Certified Accountants (ACCA) has looked at the root causes of the credit crunch and concluded: 'Excessive short-termism, coupled with a lack of accountability both within financial institutions and between management and shareholders, is at the heart of the problem.'⁷ The financial crisis has increased the focus on 'intangible' drivers and research processes. The Marathon Club, a collaboration of investment organisations representing combined assets in excess of £170 billion, believes the credit crunch has highlighted how investment professionals are too reliant on normal channels of information, such as company reporting and are failing to capture all the available relevant 'submerged' information.⁸

The principle of responsible ownership has also been put under the spotlight. Some have questioned what asset owners were doing whilst the companies they own were taking excessive risks.⁹ The financial crisis has provided a wake-up call to those trustees that did not fully understand what they were invested in and the risks they were taking. According to Ruth Murphy of Newton Investment Management, 'Some of the current problems facing the financial markets have come as a result of irresponsible business practices. ...One of the biggest lessons learnt from the current economic situation is that shareholders should be holding companies to account.'

Trusts and foundations tend to have long-term investment horizons. There is now a call for all investors and companies to think and plan long-term. According to investment consultants Watson Wyatt, there is growing recognition that emphasising short-term outcomes can be detrimental to the pursuit of long-term performance goals.¹⁰

Key Points

The financial crisis highlights the significance of accountability, transparency, the consideration of ESG research in investment processes, responsible ownership and long-term investing.

⁷ ACCA (2008) 'Climbing out of the Credit Crunch'

⁸ Marathon Club (December 2008) *Marathon Club Guidance For Long-Term Investing- Behavioural Aspects Of Investment Management: Lessons From The Credit Crunch*

⁹ See for example Bingham, K. (11 December 2008) 'Could institutional investors have prevented the credit crisis?' in www.responsible-investor.com

¹⁰ Watson Wyatt (2007) 'Investing for the Future.'

3 Fiduciary Duty

Responsible investment is based on creating value, mitigating ESG risks and taking advantage of ESG opportunities. Its financial focus means that it has a clear fit with fiduciary duty. In fact it is argued that trustees that do not take account of ESG risks and opportunities are failing in their fiduciary duty. Mercer Investment Consulting and others have argued that trustees have a fiduciary duty to address the financial risks posed by climate change.¹¹

Charity trustees are required to invest to further the purposes of the charity. This is usually seen as being achieved by seeking the best return from investments at an acceptable level of risk. Under the Trustee Act 2000, trustees have a duty to consider the suitability and diversification of investments, and for charities with permanent endowments, this includes a balance between the interests of present and future beneficiaries. It is argued that this should include a consideration of the social and environmental world that future beneficiaries will inhabit.¹² Additionally, the Charity Commission permits trustees to make investment decisions on moral grounds, provided that they are clear this will not put their charity at risk of significant financial detriment. The Commission also recognises that a charity may wish to influence a company both to ensure that its business is conducted in the charity's best financial interests and that its business does not conflict with the charity's responsible investment policy. The requirement of the Charities' Statement of Recommended Practice 2005 for charities to report on the extent to which social, environmental or ethical considerations are taken into account is an indication that responsible investment is a permissible strategy.

A study by leading international law firm Freshfields Bruckhaus Deringer for the UNEP FI investigated the legal implications of integrating ESG considerations into investment decisions. As with the Mercer report above the study was primarily focused on pension funds but its findings are relevant for all long-term institutional investors. In the firm's legal opinion, 'It may be a breach of fiduciary duties to fail to take account of ESG considerations that are relevant and to give them appropriate weight, bearing in mind that some important economic analysts and leading financial institutions are satisfied that a strong link between good ESG performance and good financial performance exists.' Freshfields also state, 'We think there is a strong argument that there will be a class of investments that could reasonably be assumed offensive to the average beneficiary such that they could lawfully be excluded from an investment portfolio without all the beneficiaries' express consent. That class of investments will not be fixed and a conservative approach is advisable, but the types of investment that might fall into that class include investments that are linked to clear breaches of widely recognised norms, such as international conventions on human rights, labour conditions, tackling corruption and environmental protection.'

The Freshfields study also recognises that the issues falling within fiduciary duty can change, 'Fiduciary duties evolve over time according to changes in social norms and the values of society and, to a degree, technological and market changes.'¹³

It can therefore be argued that the view that fiduciary duty acts as a barrier to responsible investment is outdated. All trustees should be satisfied that ESG risks and opportunities are considered in their investments. The following section examines the research conducted into the impact of ESG factors on financial performance and the mounting evidence that such issues can safeguard or enhance value.

Key Points

Addressing material ESG risks and opportunities has a clear fit with the duties of trustees. A failure to do so is seen by some as a breach of fiduciary duty.

¹¹ See for example, Mercer Investment Consulting (2005), *A Climate for Change. A Trustee's Guide to Understanding and Addressing Climate Risk* (The Carbon Trust, IIGCC and Mercer Investment Consulting)

¹² See for example Eurosif, Bellagio Forum for Sustainable Development and European Foundation Centre (2006) *Primer for Responsible Investment Management of Endowments: PRIME Toolkit*

¹³ Freshfields Bruckhaus Deringer (2005) *A Legal Framework for the Integration of Environmental, Social and Governance Issues into Institutional Investment* (UNEP Finance Initiative).

In the US Rockefeller Philanthropy Advisors, As You Sow, the Jessie Smith Noyes, Nathan Cummings, Needmor, and Rose Foundations have been among the leaders in encouraging foundations to use proxy voting to enhance their missions and to protect their endowments. In 2009, at least 19 foundations filed shareholder proposals or conducted corporate dialogues on topics including energy efficiency, executive compensation, greenhouse-gas emissions, global labour rights and sustainability reporting. The As You Sow Foundation has been an active owner for over a decade and regularly files 10-20 shareholder proposals a year and engages in a similar number of company dialogues. In 2009 these include proposals and/or dialogues on climate change and greenhouse gas emissions reduction and sustainability/carbon disclosure reporting. As You Sow also publishes an annual Proxy Preview for Foundations.

4 Financial Performance

ESG factors are increasingly recognised as having a potential impact on financial performance. The UNEP FI Asset Management Working Group commissioned a study into the links between ESG issues, financial value and company profitability. The study is based on twelve broker research reports, the expertise of more than 22 financial services firms and more than 1,000 pages of financial analysis. It concludes:

- 1 ESG issues are material – there is robust evidence that ESG issues affect shareholder value in both the short and long term.
- 2 The impact of ESG issues on share price can be valued and quantified.¹⁴

The Who Cares Wins initiative, launched by the UN Secretary-General's Global Compact Office and endorsed by financial institutions representing more than \$6 trillion in assets, has noted significant developments since its launch in 2004. 'It is today a commonly-accepted fact that ESG issues can have a financial impact on single companies or entire sectors.'¹⁵

A focus on ESG issues can enhance understanding of how companies are likely to adapt, excel or suffer in a changing context. The inclusion of ESG factors in investment analysis can help to mitigate risks and take advantage of opportunities – an approach designed to secure the long-term sustainable financial returns needed by trusts and foundations.

Mercer Investment Consulting states, 'A growing body of academic literature spanning the finance and management disciplines has demonstrated that the integration of ESG factors into a portfolio can enhance long-term returns. A substantial portion of long-term shareholder value is generated from extra financial factors not considered in the traditional metrics reported by companies and most commonly used in valuation models by analysts and fund managers.'¹⁶

The FB Heron Foundation is a US-based grant maker which seeks to use an increasing part of its assets in support of its mission. A Southern New Hampshire University case study found that 'Heron's experience during the last ten years demonstrates that the objective of achieving competitive investment returns can be met — even when incorporating mission-related investments into an overall portfolio and asset allocation. As of December 31, 2006, Heron's total fund performance was in the upper second quartile of the Mellon All-Foundation Universe on both a trailing one-year and three-year basis, with 18% of assets in market-rate mission-related investments, 6% in below market program-related investments and 3% in grants.' As of December 2006, Heron had \$308 million in assets.¹⁷

¹⁴ UNEP Finance Initiative Asset Management Working Group (2006) 'Show Me The Money: Linking Environmental, Social and Governance Issues to Company Value'

¹⁵ Knoepfel, I. & Hagart, G. (2009)

¹⁶ Guyatt, D. (September 2008) 'Integrating ESG to enhance portfolio value' (Mercer Investment Consulting).

¹⁷ Swack, M. et al (2007) 'Expanding Philanthropy: Mission-Related Investing at the F.B. Heron Foundation' Southern New Hampshire University

Most research into the performance of responsible investment focuses on ethically screened funds, rather than processes which integrate ESG factors (though we have identified examples of these in this paper), and is based on past experience. Responsible investing is based on an assessment of future trends, of how companies will react and perform in an evolving social, environmental and regulatory context. It is therefore argued that evidence of past performance is not always relevant to future financial performance.

Cary Krosinsky carried out research in the US which showed 'sustainable investing funds have significantly outperformed mainstream indices, returning +18.7% on average over the last five years, versus the MSCI World, S&P 500 and FTSE 100's returns of +17.0%, +13.2% and +13.0% respectively. Similar outperformance was seen over one- and three-year periods as well.' Krosinsky's analysis found that funds with low turnover substantially outperformed those with high velocity trading rather than ownership strategies.¹⁸

In 2007, UNEP FI and Mercer reviewed academic and broker research on the relationship between ESG factors and portfolio performance. Of 20 academic studies, it found evidence of a positive relationship in half of these, with seven reporting a neutral effect and three a negative association. The negative links were found in studies of screened portfolios rather than studies of ESG integration. The study also comments 'we are already seeing evidence of materiality in the returns that ESG integrated strategies are producing amongst practitioners (as evidenced by the broker studies also reviewed in this report).'¹⁹

The European Centre for Corporate Engagement (ECCE) summarised the findings of a number of academic and industry-backed studies on the effect of SRI investments on financial returns (see Appendix 2). The ECCE concluded from these studies 'Even though they do not present irrefutable evidence that SRI investments generate higher returns than 'normal' investments, most studies have found that they do not result in worse performance either, while, at the same time, they might actually decrease risk exposure.'²⁰ Most of these studies focus on funds that screen out companies.

As well as mitigating risks, ESG integration can help to identify opportunities for growth and development. In recent years a variety of themed funds have been launched looking at climate change, cleantech, greentech and sustainable development themes. Some sustainability-themed products, such as timber and microfinance, are seen as non-correlated investments and so useful for diversification and managing risk.²¹

A common conclusion from performance studies is that fund manager quality and strategy implementation are as important as the inclusion of ESG issues.²² As with any investment approach, the skills of the asset manager and their stock selection abilities will be critical. Appointing asset managers with the relevant skills in integrating ESG factors into their investment approach is therefore crucial.

Some investors are concerned that responsible investment will involve higher investment management fees. However, in the 2008 Responsible Investment Landscape survey only one in five asset owners felt they were paying more for responsible investment strategies.²³ The FB Heron Foundation's investment management fees in 2006 were 34 basis points, which is below the mean of other private foundations in widely known investment surveys.²⁴ Whilst initial costs

¹⁸ Krosinsky, C. & Robins, R. (2008), 'Sustainable Investing' Chapter 2.

¹⁹ United Nations Environment Programme Finance Initiative and Mercer (2007) 'Demystifying Responsible Investment Performance: A review of key academic and broker research on ESG factors'

²⁰ European Centre for Corporate Engagement (2007) 'Use of Extra-Financial Information by Research Analysts and Investment Managers'

²¹ See for example Kraussa, N. & Walterb, I. (2008) 'Can Microfinance Reduce Portfolio Volatility?' (New York University).

²² See for example, Metrick, C. (September 2008) 'Responsible investment and defined contribution plans – addressing frequently heard concerns' (Mercer Investment Consulting)

²³ Responsible Investor (2008) 'Responsible Investment Landscape 2008: Asset Owners.'

²⁴ Swack, M. et al (2007) 'Expanding Philanthropy: Mission-Related Investing at the F.B. Heron Foundation' Southern New Hampshire University

could be higher, benefits can be greater in the long run. ESG integration can be seen as an insurance approach, which safeguards returns which would otherwise have been forfeited.²⁵

It is the risk of not acting, of not considering ESG factors that poses risks and potentially significant costs to investors. The following section explains why ESG factors can be material and gives examples of financially relevant issues.

Key Points

There is growing evidence that ESG integration can safeguard and enhance returns. Research commissioned by UNEP FI found robust evidence that ESG issues affect shareholder value in both the short and long term.

The Needmor Fund is a small US foundation which has employed a mission related strategy for over fifteen years (this includes screened equities, an active share owner engagement programme and deposits with community banks). In 2006 the foundation had investments of \$26 million. Sarah Stranahan compared the recent financial performance of these investments with a foundation that was started by the same family, uses the same investment consultant and has a similar investment strategy, but does not consider mission related issues in its investments. In the year to October 31st 2008, Needmor was down 24.1% and the traditional foundation was down 28.6%. Over a five year period Needmor was up 3.6% compared to the traditional foundation's 3.2%. Stranahan believes asset allocation accounts for some of the difference - particularly Needmor's overweight position in cash and fixed income. But she puts 2.5% of Needmor's 4.5% outperformance down to the quality bent of their equity fund manager. She argues that this acts as a modest hedge and helps to reduce volatility.²⁶

5 ESG Risks and Opportunities

The most financially-relevant ESG factors can arise from the actions and reactions of regulators, consumers, suppliers, employees and financial markets. Material factors will vary across sectors. For example, supply chain issues and reputation damage can be key for the retail sector, water resource constraints may be increasingly important for beverage companies, and risk control and quality of lending will be significant for the banking sector. This section describes just three of the many ESG factors which can be material for investors.

Trustees do not have to become experts in an array of ESG concerns. Rather, they should ensure that asset managers have such expertise.

The Wellcome Trust is by far the biggest charity investor in the UK. Writing at the end of 2008, Danny Truell and Nick Moakes gave their views on the future investment trends for the Trust, 'We believe that the strong performance of most financial assets between the start of the 1980s and the middle of 2007 was underpinned by the secular decline in bond yields around the world over that time. We doubt that that favourable wind will continue over the next decade or so. We are therefore focusing increasingly on long-term themes that we see as key to global economic activity in future. Among these, we are especially interested in the broad area of scarce resources including energy, environment, food and water; the impact of ageing on society; the emergence of new drivers of global growth in Africa, Asia and Latin America; and the development of a knowledge economy in the developed world.... As the world changes, the portfolio will continue to adapt and evolve to meet the Trust's mission.'²⁷

²⁵ See for example Knox S & Maklan S (2004) 'Corporate Social Responsibility: Moving Beyond Investment Towards Measuring Outcomes' *European Management Journal*

²⁶ Stranahan, S (January 11, 2009) 'A tale of two foundations' in *Responsible Investor*

²⁷ Truell, D. & Moakes, N. (2008) 'Going for growth: What makes a successful investment strategy?' In *Effect magazine* winter 2008

5a Governance

The credit crunch and near collapse of the banking sector has put governance under the spotlight and highlighted the potential consequences of poor performance in this area. It is now widely recognised as an issue that all investors should consider – the way in which a company is governed is seen as key to the way it performs.

Remuneration structures have been criticised for creating excessive short-termism which, along with poor risk management, acted against the long-term interests of companies and their shareholders. Investors are increasingly looking to companies to incentivise long-term thinking and longer-term performance.

As leading responsible investment proponent Hermes states, 'Corporate governance is increasingly considered to be an integral part of a trustee's fiduciary duty, as well as enhancing the long term performance of their investments.'²⁸ In 2008 the Association of British Insurers (ABI) published research showing that companies with the best corporate governance records produced returns 18% higher than those with poor governance. The research also shows that shareholders investing in a poorly governed company suffer from low returns. £100 invested in a company with no corporate governance problems leads to an average return of £120 but if invested in the worst governed companies the return would have been just £102. The ABI also found that the volatility of share returns is 9% lower for well-governed companies than poorly governed companies.²⁹

Mark Steinert, Global Head of Equity Research at UBS Investment Bank commented, 'Now more than ever before, assessing a company's relative governance characteristics is critical to investment analysis,'³⁰

The key governance issues include board structure, independent board leadership, separation of Chairman and CEO, executive compensation, shareowner rights, accounting and audit quality and corporate culture.³¹

Understanding of governance issues is evolving to include the broader management of risks, including ESG risks, particularly at board level. Research conducted by EIRIS in 2009 found that whilst companies in the FTSE All World Developed Index improved ESG risk management between 2005 and 2008, in 2008 only a quarter of companies disclosed adequate risk management and that the financial sector showed the poorest performance of all of the sectors.³²

Key Points

Poor corporate governance has been shown to have serious consequences. The way a company is governed can affect its performance and should be a concern of all shareowners.

The Joseph Rowntree Charitable Trust is one of the pioneers of responsible investment. It employs negative and positive screens as well as an active ownership strategy on its portfolio, which has outperformed its benchmark in seven of the last nine years.

²⁸ www.hermes.co.uk/eos_value_creation.aspx

²⁹ ABI (2008) 'Governance And Performance In Corporate Britain'

³⁰ UBS press release (8 November 2008)

³¹ Guyatt, D. (September 2008) 'Integrating ESG to enhance portfolio value' (Mercer Investment Consulting)

³² EIRIS (2009) *At risk? - How companies manage ESG issues at board level*

5b Climate Change

Whilst some financially material ESG issues vary by sector and company, there is a growing consensus that climate change will be financially significant to all companies. It presents a systemic risk and the Stern Review³³ clarified the threats posed to the economy and the financial impact of not addressing climate change.

Climate change presents risks (as well as opportunities) for all investors. EIRIS has summarised these as:

- **Regulatory challenges** – national and international policy frameworks for reducing Greenhouse Gas (GHG) emissions are providing an imperative to reduce operational emissions. The Kyoto Protocol entered into force in 2005 with GHG reduction targets, and will be succeeded by the Copenhagen treaty in 2013. Existing and emerging product standards (such as the EU Directive on the Energy Performance of Buildings), environmental taxes and compliance costs now need to be factored into companies' operational costs.
- **Changing market dynamics** – higher and fluctuating energy costs, along with the Emissions Trading Scheme now in operation across the EU, present a significant impact, in particular for energy-intensive industries such as electricity, oil and gas, manufacturing and transportation.
- **Changing weather patterns** – the physical risks of climate change include damage to assets as a result of flooding, storms, rising sea levels and other extreme weather events. Sectors such as agriculture, forestry, insurance, tourism and fisheries could be most affected.
- **Reputational** – customer, employee, investor and societal perceptions are having an increasing impact on brand value.³⁴

Climate change is not just an issue that will affect future generations and be relevant for long-term investors. As Susanna Jacobson of Mercer Investment Consulting explains, 'The impact of climate change is being felt now. Companies are already the subject of national and international regulations and emissions trading.'

As well as facing a number of risks, there are opportunities that climate change presents for companies and investors. Companies that mitigate climate risk may be able to gain competitive advantage in relation to peers – due to reduced costs, access to new markets or improved reputation. The fiscal stimulus packages announced by Barack Obama and others include a focus on the renewable energy sector. For reasons of energy security, job creation and carbon risk, renewable energy technologies and energy efficiency developments are likely to receive significant investment.

Of course, as well as the financial case for considering climate change in investments, there is a strong mission case for charities to consider the issue. As organisations with a social or environmental mission, trusts and foundations should be concerned about the world in which current and future beneficiaries will live. Organisations that provide grants to environmental projects should also use investments to tackle climate change and ensure they are not undermining programme work through investments.

Key Points

Climate change presents a systemic risk for investors. Regulation, resource constraints, emissions trading, the price of carbon and waste disposal are already having an impact on company operations. Investors should be mitigating the risks and taking advantage of the opportunities presented by climate change.

The Paget Charitable trust has investments of around £4 million. It employs a number of screens on its portfolio and has also invested in wind farms. Joanna Herbert-Stepney recalls, 'We invested in wind farms because it was a good financial investment. We would not have invested just for environmental reasons.'

³³ Stern, N. (2006) *Stern Review: The Economics of Climate Change*

³⁴ Adapted from EIRIS (2008) 'The state we're in: global corporate response to climate change and the implications for investors'

5c Social Factors

There are also a range of social issues that can be financially relevant – the extent of their potential financial impact can vary by sector. Issues such as labour standards in supply chains, human rights, health and safety, bribery and corruption and stakeholder relationship management can be material.

The CFA Institute recognises that such issues play a significant role in the public's view of companies. 'News of a poor safety record or the use of forced labour has the potential to damage a company's reputation. That negative reputation, in turn, adversely affects the financial prospects of the company in the public eye by depressing revenue or prompting new regulatory burdens. ... Investors need to understand the social risks that threaten the reputation and brand integrity of the companies in which they invest.'³⁵

Companies with good corporate social practices and stakeholder relationships can enjoy the benefits of customer loyalty, employee retention and social licence to operate whilst reducing the risks arising from safety issues (consumer, employee and community), potential boycotts and loss of corporate reputation.³⁶

Key Points

Social factors such as labour standards, community relations or health and safety can negatively impact a company's reputation and brand value, which can have consequences for financial performance.

The experience of the Nuffield Foundation demonstrates that investments made for financial reasons can also fit with the mission of the organisation. The Foundation does not see itself as making mission investments, but has made investments that could be seen as supporting its mission. James Brooke Turner, commented, 'The investment committee has invested in a medical venture company, strictly as an investment however. The fact that it aligns with our mission is welcome but incidental.'³⁷

³⁵ CFA Institute Centre for Financial Market Integrity (2008) 'Environmental, Social, and Governance Factors at Listed Companies: A Manual for Investors'

³⁶ Knox S & Maklan S (2004) 'Corporate Social Responsibility: Moving Beyond Investment Towards Measuring Outcomes' *European Management Journal*

³⁷ Quoted in Nissan, S. & Bolton, M. (2008) 'Mission Possible: Emerging opportunities for mission-connected investment' (New Economics Foundation).

6 What Are Other Asset Owners Doing?

Most trusts and foundations have tended to be behind the curve when it comes to responsible investment. Trustees can benefit from the skills and techniques employed by a growing group of mainstream asset managers and owners that integrate ESG issues.

Responsible investment is no longer the preserve of a handful of niche investors. In 2007 one in nine investment dollars run by fund managers or institutional investors in the US was managed following socially responsible principles.³⁸ Whilst in Europe at the end of 2007 the SRI market was estimated to represent €2.7 trillion in assets. The UN PRI encourages investors to integrate ESG factors into investment and become active shareholders. It is one of the largest ever institutional investment coalitions comprising over 470 asset owners and managers representing assets of \$18 trillion an indicator of the growing recognition of responsible investment as a value driver. Over 50 UK organisations are signatories including public and corporate pension funds and asset managers. Six international (but no UK) trusts and foundations have so far signed up to the principles. Through the UN PRI, investors are collaborating to engage with companies, to improve company behaviour, policies or performance.

European public pension funds have been leading the way in relation to responsible investment. A number of prominent funds have put ESG integration at the core of their investment strategy and have also invested in the renewables sector. Examples include the Universities Superannuation Scheme and the Environment Agency Pension Fund in the UK and ABP and PGGM in the Netherlands.

The French pensions reserve fund (FRR) adopted a responsible investment strategy in April 2008 aimed at tracking and preventing the extra-financial risks that could have an impact on the fund's reputation. The FRR makes reference to the fundamental norms and standards related to the ten principles of the UN Global Compact as the basis for its responsible investment strategy. The fund's approach consists of identifying companies that are accused of breaching these principles and engaging with the worst offenders. Nada Villermain-Lecolier, head of responsible investment at FRR, says the fund operates with an "internal conviction" that integrating ESG factors into investment maximises risk-adjusted returns over the long-term. The FRR operates a broader policy of integrating ESG factors into the investment mandates of all the asset managers it hires, in line with the aims of the UN PRI, and votes all its shares globally.

The activities of these asset owners has helped to drive the development of responsible investment products and approaches. They have demonstrated the feasibility of ESG integration. Trusts and foundations should now follow suit, ensuring that their investments take full and proper account of material risks and opportunities, to find out how, see the 'Practical steps' section below.

Key Points

Responsible investment practices have been pioneered by a range of mainstream investors, including high profile public pension funds. Signatories to the UN PRI now represent \$18 trillion, an indication of the growing recognition of ESG integration as a value driver.

³⁸ Social Investment Forum (2007) '2007 Report on Socially Responsible Investment Trends in the United States'

7 Practical Steps

If your trust or foundation is interested in responsible investment there is a range of steps you can take – which require a varying amount of time or resources:

1 Agree your position

The first step for any trust or foundation considering responsible investment is to determine your beliefs and position in relation to responsible investment. This could involve examining the available information (see for example the additional resources section at the back of this paper), and bringing internal or external experts to meetings. This may involve the advisers and investment managers listed in www.charitysri.org or other foundations with a responsible investment approach.

2 Research your investment manager's expertise

Once your board has agreed that it wishes to address ESG risks and opportunities, a simple next step is to look into the expertise and skills of your current investment manager(s) and determine if they currently or could potentially meet your needs. Seeking assurance from fund managers that they are incorporating ESG factors into research and investment processes can also encourage more fund managers to take action in this area. Explicit demand from clients is likely to prompt a wider adoption of ESG integration.

An initial assessment can be made of the investment manager's commitment to responsible investment and involvement in ESG related initiatives through the following sources:

- Are they a signatory to the UN PRI? (www.unpri.org/signatories) Is their UN PRI assessment publicly available?
- How well do they rate in the FairPensions ranking of fund managers according to engagement practices, integration of environmental and social issues, and transparency? (www.fairpensions.org.uk/benchmarks)
- Are they a member of the Institutional Investors Group on Climate Change? (www.iigcc.org/membership.aspx)
- Are they a signatory to the Carbon Disclosure Project? (www.cdproject.net/signatory-investor-listing.asp)

Other information may need to be obtained directly from your asset manager. Appendix 3 includes a list of suggested questions.

Trusts and foundations that use the services of an investment consultant could ask them to investigate the approach of investment managers to ESG integration. Mercer, for example, has started to incorporate such research into their mainstream rating of managers.

3 Include ESG integration in your investment mandate

Trustees should ensure that ESG integration forms part of their contractual agreements with asset managers. Penny Shepherd, Chief Executive of UKSIF, believes, 'Trustees need to integrate sustainability issues fully into their governance role. This is about investment beliefs and improved contractual relationships, not about usurping the roles of investment consultants or fund managers. Quality of responsible investment must become a significant factor in the awarding and retaining of mandates.' Aviva Investors, for example, announced in 2008 that it will include a clause on responsible investment in all of the contractual investment management agreements proposed to clients.

4 Join collaborative initiatives

Trusts and foundations can sign up to collaborative initiatives such as the Carbon Disclosure Project. Even with a small asset base, the name and reputation of foundations can add weight to initiatives that encourage companies to improve their performance or practices in relation to ESG issues. Trusts and foundations with a strong commitment to responsible investment could join the UN PRI.

5 Vote your shares on ESG related issues

Trustees can look into the voting record of investment managers and instruct them to vote your shares on ESG issues. This may be particularly relevant for investors in US stocks where there are many ESG resolutions.³⁹ Investors in pooled funds can encourage fund managers to do the same.

6 Engage with companies directly or via asset managers

You can encourage companies to improve ESG practices, performance and reporting.

7 Invest in themed funds such as greentech, microfinance or timber

In recent years there has been a proliferation of sustainability themed funds, providing opportunities to invest in companies and projects that tackle climate change, provide solutions or alternative energy sources. Some investors use these funds as 'satellite portfolios' to provide uncorrelated returns to the core holdings. There are opportunities to invest in private equity, property and fixed income as well as equities.

8 Invest in responsible investment funds that use ESG integration

There are a variety of funds – sometimes termed socially responsible investment (SRI) funds which use techniques for integrating ESG issues, engaging with companies or investing in companies with positive ESG practices.⁴⁰

Key Points

Trusts and foundations should discuss the arguments presented in this paper and decide if they wish to incorporate ESG risks and opportunities in their investments. Research and interaction with fund managers should determine the extent of their expertise and activity in this field. Trusts and foundations can also join collaborative initiatives and become active owners – voting shares and engaging with companies.

The Swedish Foundation for Strategic Environmental Research, Mistra, supports research to promote sustainable development and ensure a healthy environment. It aims to manage its assets in a way that balances limited risk-taking with the seeking of high returns. The Foundation's investment strategy is designed to take ESG criteria into account. Mistra follows the asset managers' work to integrate sustainability into the mandates. Mistra has been active in the area of responsible and sustainable investment.

³⁹ Details of these can be found in the proxy preview published annually by the As You Sew Foundation

⁴⁰ A database of SRI funds can be found at www.charitysri.org

8 Conclusion

Trustees have a duty to ensure that assets are used in their organisation's best interests. For most this means safeguarding assets for current and future beneficiaries. The recent financial crisis has exposed the risks that investors, including trusts and foundations, were exposed to and the disconnect between shareowners and companies.

As this paper illustrates, mainstream investors are increasingly recognising the financial significance of environmental, social and governance factors in determining their investment decisions. Regulation and resource constraints mean that climate change will impact company practice and performance. The ways in which companies manage climate change risks and take advantage of opportunities should be considered by investors.

The integration of ESG factors into investment processes is no longer seen as radical or ethical, but is recognised as a way to enhance value. The number and range of asset owners and managers that are signatories to the UN PRI demonstrate that responsible investment is becoming part of the mainstream. It is increasingly seen as best practice.

Given the financial relevance of ESG factors it could be argued that trusts and foundations that fail to take these issues into account are acting imprudently. To safeguard assets for future beneficiaries trusts and foundations should ensure their investments are managed to mitigate ESG risks and take advantage of ESG opportunities. It is not enough to assume that this is being taken care of. Acting as responsible owners, trusts and foundations should question and encourage asset managers to act.

Appendix 1. Additional Resources

Charity SRI
www.charitysri.org

More for Mission
www.moreformission.org

United Nations Principles for Responsible Investment
www.unpri.org

A Climate for Change. A Trustee's Guide to Understanding and Addressing Climate Risk (2005) The Carbon Trust, IIGCC and Mercer Investment Consulting

A Legal Framework for the Integration of Environmental, Social and Governance Issues into Institutional Investment (2005) Freshfields Bruckhaus Deringer and UNEP Finance Initiative

A Toolkit for Foundations and Individual Investors: Harnessing Your Investments to Help Solve the Climate Crisis (2008) CERES, Investor Network on Climate Risk and Environmental Grantmakers Association.

CC14: Investment of Charitable Funds - Basic principles (2004) Charity Commission

Fiduciary Duty (2008) Viederman, S in Krosinsky, C. & Robins, R. (Eds.) 'Sustainable Investing: The Art of Long Term Performance.' Earthscan.

Mission in the Marketplace: How Responsible Investing Can Strengthen the Fiduciary Oversight of Foundation Endowments and Enhance Philanthropic Missions (2009) the Social Investment Forum Foundation.

Primer for the Responsible Investment Management of Endowments (PRIME) Tool Kit (2006) the European Foundation Centre, European Social Investment Forum and the Bellagio Forum for Sustainable Development.

Unlocking the Power of the Proxy: How Active Foundation Proxy Voting Can Protect Endowments and Boost Philanthropic Mission (2004) As You Sow Foundation and Rockefeller Philanthropy Advisors.

Appendix 2. ECCE Summary of Performance Studies

Authors	Year	Market studied	Period studied	Outcome
Bauer, Koedijk, Otten	2004	Germany, UK, US	1990-2001	No difference
Bello	2005	US	1994-2001	No difference
Boutin-Dufresne, Savaria	2004	Canada	1995-1999	No difference
Derwall, Guenster, Bauer, Koedijk	2003	US	1997-2002	"Good" stocks outperform
Derwall, Guenster, Bauer, Koedijk	2005	US	1995-2003	"Good" stocks outperform
Foerster, Asmundson	2001	Canada	1995-1999	No difference
Gluck, Becker	2004	US	1998-2003	Incorporating SRI higher alpha
Hong, Kacperczyk	2006	US	1962-2003	"Bad" stocks outperform
Kempf, Osthoff	2006	US	1991-2004	"Good" stocks outperform
Mill	2002	N/A	1982-2002	No difference
SRI World Group	2002	US	1999-2001	No difference
Statman	2000	US	1990-1998	No difference
Statman	2005	US	1990-2004	No difference

Appendix 3. Questions for Asset Managers⁴¹

The following list of suggested questions can be posed to your asset manager:

- Have you developed internal expertise in responsible investment/ESG integration?
- What level of understanding and experience do your investment analysts and portfolio managers (across different asset classes) have in relation to ESG issues?
- Do you have any individual or group with a dedicated focus on climate change or ESG factors? If yes, how does that group relate to your traditional operations?
- How often are climate change and other ESG issues discussed with company management? Are these issues addressed during specific meetings between ESG/responsible investment specialists and management, or as part of your mainstream analyst meetings with management?
- What are some of the ESG related discussions you've had with company managements in the past 12 months?
- Do you purchase any external research, or participate in any external networks on this issue?
- Is there a process for ensuring ESG risks are built into your traditional investment decision-making process? How is this accomplished?
- How do you encourage brokers to include analysis of these issues in their research notes?
- Are there mandate qualities or particular benchmarks which would encourage ESG issues to be better incorporated into investment decision-making?
- Do you collaborate with others to address climate change and other ESG risks and opportunities?
- Can you incorporate a regular discussion of ESG analysis into our fund's monitoring reports?

⁴¹ Adapted from Mercer Investment Consulting (2005), 'A Climate for Change. A Trustee's Guide to Understanding and Addressing Climate Risk' (The Carbon Trust, IIGCC and Mercer Investment Consulting)



The Charity Project is an EIRIS Foundation initiative which encourages and assists charities and their trustees in the development of a responsible and sustainable approach to their investments through education, research and the provision of resources. The EIRIS Foundation is a charity established by a group of churches and charities wishing to know how they could best invest in line with their values.

The Foundation owns a trading subsidiary, EIRIS, which conducts research into almost 3,000 companies globally according to environmental, social, governance and ethical criteria.

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