

The Intentionally Designed Endowment

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TAKEAWAYS

Challenges such as climate change, resource scarcity, human rights, and water shortages are driving public purpose institutions to mobilize private sector capital to have positive health, social, and environmental impacts. Many colleges and universities are now pursuing so-called sustainable investment strategies.

There is no singular “right way” to approach aligning endowment investments with institutional mission, values, and the goal of contributing to a healthy, thriving society. Each institution must create its own strategy based on its culture, circumstances, and governance processes.

Endowment policy has attendant risks and benefits. Students and other constituents have a strong interest in contributing to social good. Taking a proactive, positive approach may offer opportunities to appeal to new applicants, encourage gifting, and increase engagement.

In April 2014, 120 leaders from nonprofit institutions and members of the investment industry convened to explore the emerging concept of the intentionally designed endowment—one that meets the financial needs of institutions through investment strategies aligned with their environmental, social, and governance (ESG) goals to fulfill their missions. The group discussed a range of topics, including sustainability, social responsibility, the consideration of ESG factors in the investment process, impact investing, and the role of institutional mission in endowment management.

For many, interest in the topic was sparked by calls from students and other constituencies for divestment from fossil fuel holdings. However, regardless of whether an institution decides to divest (from fossil fuels, private prisons, or any other sector or company), there is growing consensus that it is incumbent upon fiduciaries to ensure that investment managers consider ESG factors to reduce financial risk and identify investment opportunities in the context of the 21st century economy.

STATE OF THE FIELD

In recent years, investors of all kinds have been adopting sustainable investment strategies. According to the US SIF Foundation’s 2016 *Trendsreport*, total U.S. assets employing sustainable, responsible, and/or impact investing strategies were \$8.72 trillion—22 percent of all

institutionally invested funds. This represents a 33 percent increase since US SIF's 2014 report and a 14-fold increase since reporting began in 1995.

Investment consultants, managers, and asset owners are increasingly looking at ESG factors as positive influences on longterm value, volatility, and risks of specific investments. As a result of this shift in institutional thinking, the market is providing endowments with more options when pursuing sustainable investing strategies, simply because it makes financial sense.

Barriers to sustainable investing remain. The terminology lacks consistent definitions, which can lead to confusion. In addition, the field lacks consistent standards—a challenge being addressed by groups such as the Sustainability Accounting Standards Board. Companies' limited and inconsistent data and disclosure on ESG issues present additional challenges. Finally, institutions lack basic understanding of the importance of this kind of investing and resist consideration of ESG factors as material to decision making.

MODELING A LIVABLE SOCIETY

Higher education has a social contract: In exchange for tax-exempt status and the ability to receive public and private resources, it provides the knowledge and educated citizenry to enable a thriving, civil, and sustainable society.

Higher education is one of the few sectors designed to think and act for the long-term good of society. It can solve current problems, anticipate future challenges, and set a behavioral model. It is appropriate that these institutions align all actions, including investments, with social good. As an example, through the Presidents' Climate Leadership Commitment, more than 600 colleges and universities have made a publicly accountable commitment to become carbon neutral in their operations, build resilient campuses and communities, and transform education.

Compared with religious institutions, philanthropic foundations, family offices, and pension funds, higher education endowments have lagged on sustainable investing. However, this is shifting as more colleges and universities align endowment investments with the mission of ensuring a safe and livable society.

MEETING FINANCIAL GOALS

There is a large and growing body of evidence that indicates investors need not sacrifice financial returns by considering mission or ESG factors. ESG factors are material and critical to sound investing, and ESG investment strategies outperform conventional investing most of the time.

As with any investment product, some ESG strategies (and managers) perform better than others and comparable non-ESG strategies and managers. In recent years, the amount of data on ESG investing has grown significantly, providing evidence that ESG investment often outperforms traditional strategies. One recent meta study found that 89 percent of research studies showed that companies with high ESG ratings outperform industry peers. A recent Harvard Business School study showed that 90 companies with strong sustainability policies outperformed a

similar group with low sustainability standards, with a 4.8 percent higher annual above-market average return between 1993 and 2011. As shown in the graph above, the difference in stock performance between the top 10 percent and the bottom 10 percent demonstrates the potential for strong financial returns. Hampshire College's average five-year investment returns have performed better (6.4 percent) than the average return of the more than 800 colleges tracked by both NACUBO Commonfund Study (5.4 percent) and Bloomberg Endowment Index (4.5 percent).

Hampshire College was among the first colleges to adopt socially responsible investment (SRI) policies in the 1970s, and the first to divest from South Africa to protest apartheid. In 2011, Hampshire adopted an overtly ESG investment policy that emphasized positive screening and active investment in companies that aligned with the college's mission. The policy is grounded on the premise that long-term risks are higher when businesses do not effectively address material ESG issues. As a result, consideration of ESG principles is part of the college's fiduciary duties.

Many colleges and universities are now pursuing sustainable investment strategies. The University of California (UC) Regents Investment Office, which manages approximately \$100 billion, is developing ESG strategies across its investments and has committed to investing at least \$1 billion in solutions to climate change by 2018. In 2016, the University of Massachusetts Foundation was the first major public institution to announce it would divest from all direct fossil fuel holdings and utilize ESG factors in all investing. San Francisco State University's (SFSU) Foundation committed to fossil fuel divestment, allocated \$5 million to establish a green investment fund, and created a \$500,000 student-managed SRI investment fund. In 2016, Becker College became the first higher education endowment to pursue a 100 percent impact investment strategy. The approach will include metrics on health, income, equality, environment, diversity, and transparency.

FIDUCIARY DUTY

Can fiduciaries pursue investment strategies that are aligned with an institution's mission and values and a desire to have a positive impact on society? In its simplest form, fiduciary duty requires trustees to act with loyalty and prudence.

- The duty of loyalty requires a fiduciary to put the interests of the institution ahead of his or her own.
- The duty of prudence requires a fiduciary to act with a level of care that a prudent businessperson would employ.

Given the desire not to run afoul of these duties, many trustees act in ways that leave a substantial margin of error to avoid claims that they are not fulfilling these duties. Some fiduciaries raise concerns that considering ESG factors would violate these duties, if the reasons for doing so were beyond the scope of maximizing financial returns.

Recent guidance on this topic from both scholars and the government indicate that considering ESG and/or mission-related factors in the investment process is in line with fiduciary duties.

Increasingly, industry experts are making the case that fiduciary duty *requires* that ESG factors be considered, as they are material to the success of the institutions in which they invest.

In 2015, the Department of Labor issued guidance for fiduciaries under ERISA. It stated: “Environmental, social, and governance issues may have a direct relationship to the economic value of the plan’s investment. In these instances, such issues are not merely collateral considerations or tie-breakers, but rather are proper components of the fiduciary’s primary analysis of the economic merits of competing investment choices.”

Moreover, an emerging concept of interest is intergenerational neutrality. This principle says that institutions serving long-lived constituencies (e.g., future students, faculty, and staff) must, as part of their fiduciary duty, serve all generations equally. It suggests that a longer view on financial returns, and consideration of existential issues such as climate change, are appropriate and obligatory. Climate change-related issues have multiple dimensions, including intergenerational equity, risk-adjusted returns, and carbon-based assets not being worth their long-term carrying value.

For an institution interested in pursuing ESG investing, an important step is to reexamine its mission and purpose and how they flow into its investment policy. The process will vary among institutions. Some missions and purposes, such as those that guide a Jesuit institution, will be obvious; others will come from the institution’s academic and cultural orientation. Such a reexamination opens up opportunities to engage the campus community in this conversation.

Once these ideas and concepts coalesce, the institution’s investment advisor and staff can help craft an aligned investment policy. As these issues evolve, a principle-based approach, rather than a focus on particular current industries or issues, is more likely to remain relevant and sustaining over time. While the board of trustees is charged with how investments are made and managed, it may be worthwhile to consider establishing a vehicle or mechanism for the institutional community members to express concerns to the board.

CONSTRUCTING AN INVESTMENT PORTFOLIO

While issues of portfolio construction are largely beyond the scope of this article, there are some key factors to consider:

- Investing aligned with mission does not mean a complete portfolio turnover, nor is it a one-time endeavor. With a well-constructed Investment Policy Statement, the portfolio can move in this direction over time and in accordance with normal, healthy turnover of holdings.
- Choosing good managers remains an important driver. The universe of highperforming ESG investment options is growing. This is true in virtually all asset classes and types of strategies.
- Consider investment options in context with the role they play in the portfolio (e.g., emerging markets, natural resources, impact investing). A rapidly growing number of investment alternatives can help mitigate risk and volatility so the portfolio can maintain

prudent asset allocations, alignment with indices, liquidity, and broad-based market exposures.

- As owners, endowments can help improve corporate ESG performance through active shareholder engagement. This moves the institution into the role of being an active steward, with compelling opportunities for mission alignment and education.

INVESTMENT TRANSPARENCY

As most institutions of higher education are organized as not-for-profit entities, their constituencies and markets are made up of faculty, staff, students (current and future), alumni, and the broader communities they serve. With rare exception, none of these groups expect the institutions to maintain secrecy regarding the endowment.

By being transparent about holdings, educational institutions offer the opportunity for greater accountability in their governance and further their educational mission by offering information supportive of their educational objectives. There is no singular “right way” to approach aligning endowment investments with institutional mission, values, and the goal of contributing to a healthy, thriving society.

There are many strategies that come by many names, including sustainable, ESG, impact, and shareholder engagement. Each institution must chart its own course aligned with its culture, circumstances, and governance processes. But as we move further into the 21st century, social and environmental costs will continue to be internalized by the companies and projects in which endowments invest because it is necessary to create a more inclusive, just, and environmentally sustainable economy. Investor opportunities associated with large flows of capital into sustainability solutions should and will continue to grow and thrive.

Reputational risks and benefits are associated with endowment policy. Students and other on- and offcampus constituents have a strong (and increasingly vocal) interest in issues such as climate change, private prisons, and investments for social good. Taking a proactive, positive approach may offer opportunities to appeal to new applicants, encourage gifting, and increase engagement. Millennials, in particular, are focused on making positive contributions to the world. Being able to state that your institution is doing this, not only philosophically, but also in how it educates and acts across its operations (and in its endowment), can be a significant factor in encouraging thoughtful, active students and alumni. Increased transparency through technology and social media can rapidly bring once remote and rarely considered issues directly to campus in high definition.

It may be tempting to dismiss calls for divestment from fossil fuels as the latest trend in a long history of student activism. However, unlike previous divestment movements, current calls for institutions to invest in ways that advance societal sustainability invite consideration of the larger implications of a board’s obligation to maintain intergenerational equity and provide thought leadership about an existential issue. Investment professionals are increasingly looking at ESG criteria as factors that positively influence long-term value and potential riskiness of specific investments.

Fortunately, presidents, trustees, and endowment managers do not have to do this alone. The Intentional Endowments Network was created to provide a venue for busy endowment decision-makers to learn about and stay up to speed with this emerging and dynamic field and address these issues in ways that are appropriate to their individual values and culture.

As fiduciaries, trustees can no longer ignore ESG issues, or simply assume that investment analysts and managers will automatically integrate such factors. By being intentional about the positive social and environmental impacts of endowment investments—in addition to ensuring strong financial returns—fiduciaries can ensure that all the institution's activities are supporting its mission, and a positive future for the students of today and tomorrow.