Global Asset Management

MAXIMUM IMPACT

Achieving Diversification with Responsible Investments

Introduction

Responsible investing (RI), is not a new concept; in fact, according to some estimates the term was first coined over a decade ago in 2007. Since that time, the field has evolved rapidly. What started out as a smaller niche industry available only to a few private investors and philanthropists is well on its way to becoming mainstream. According to the Forum for Sustainable and Responsible Investment (US SIF), one in five investments in the U.S. takes environmental, social and governance issues into consideration.[1] Because of this growth, it is now possible for investors to dedicate their entire portfolio to responsible investing and still achieve diversification across multiple asset classes without sacrificing return. Heightened demand is behind the spike in the number and type of investment options that are now available to investors who are seeking the double bottom line from their investments.

There are many different approaches and definitions of RI. The graphic below illustrates three: one passive or screens-based approach - Ethical - and two active approaches - ESG and Impact. Within this paper, RI will refer to the two types of active investment approaches. The first approach, ESG, includes those investments that "aim to incorporate environmental, social and governance (ESG) factors into investment decisions."[2] For example, as pertains to the environment, a responsible investor may look for companies that do not harm the environment with their products or practices or that create services/ products that help the environment. Socially, one might look for investments that provide supports aimed at improving the quality of life of those that live in low to moderate income communities. For those focused on governance, an evaluation of corporate governance practices and proxy voting methodologies is necessary in order to ensure corporate responsibility.

The second approach is impact investing, which offers investors the ability to earn a return while also targeting social causes and directing their investments towards those select causes. The field of impact investing is rich with creativity and enthusiasm. Impact investments are available in support of many various impact arenas, including affordable housing, health care facilities in underserved areas, job training programs and access to higher education. The possibilities are limitless. In this paper we will explain how it is possible to invest an entire portfolio in responsible investments and still maintain diversification without sacrificing return.

Exhibit 1

Ethical

Exclude socially adverse industries like tobacco, alcohol, and weapons

ESG

Seek investments with strong Environmental, Social, and Governance policies

Impact

Select investments that have a direct impact on positive social change

Responsible Investing

Source: hedgeable.com

[1] US SIF Foundation's 2016 *Report on Sustainable and Responsible Investing Trends in the US*, as of November 2016.
[2] United Nation's-supported Principles for Responsible Investing (UN PRI) network.

Investment Options Across Asset Classes

In recent years there has been a growing interest in responsible investing, an idea that grows out of more than a century of efforts to combine traditional return-seeking investment approaches with efforts to also pursue non-financial goals. In the past, these efforts were often labeled "socially responsible investing" and focused on the negative: avoiding or divesting holdings in companies that engaged in activities deemed inappropriate, whether that might be producing armaments or tobacco products or having employment policies seen as retrogressive. As this approach has continued to evolve, however, it has moved from avoidance to a more positive approach of seeking out—and often developing—investments that make a positive contribution to the investor's social goals while earning an economic return. This approach, called "impact investing," can take a variety of forms.

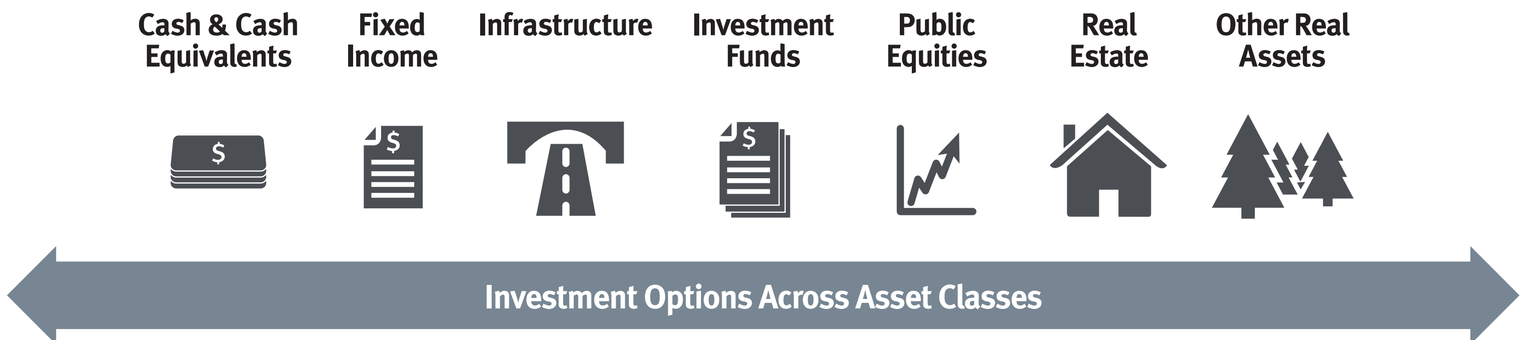
The Global Impact Investing Network (GIIN) estimated that impact investments totaled over $77 billion as of year end 2015.[3] According to their 2016 Annual Impact Investor Survey, private equity and private debt are the most common instruments used in impact investing, with allocations to private debt significantly outweighing allocations to private equity.[4] That said, impact investors allocate their capital across a broad spectrum of asset classes and investments.

It is important to emphasize that impact investing is focused on genuine investments that have the potential to earn meaningful financial returns. A variety of foundations, endowments, and pension funds are involved in making impact investments as are numerous individuals. Impact investors understand that the portfolios they are overseeing must continue to generate the financial resources needed to support and advance their objectives, which may range from paying pensions to supporting universities or funding charities. However, they also understand it is possible to achieve those goals while simultaneously advancing social causes. Impact investors frequently talk about a "double bottom line," in which both financial and social goals are advanced. Exhibit 2 is intended to highlight the fact that there are responsible investments available in all major asset classes.

Cash & Cash Equivalents: RI options within this asset class are available through community banks or community development finance institutions (CDFIs). Deposits made into community banks and community development financial institutions help local communities by providing financing to businesses, funding affordable housing units and assisting individuals with training programs and education.

Public Debt: There are many options available to RI investors within this asset class, including: single family agency mortgage-backed securities (MBS); multifamily agency MBS; taxable municipal bonds; Small Business Administration (SBA) loans and even green bonds, which are used to fund projects with environmental benefits. One key advantage of investing via public debt is the ability to customize. In many instances, these instruments may be targeted towards a specific geographical region or public works project selected by the investor. This ability to target geographic and demographic areas in which to invest and support is appealing to many RI investors as they have the ability to see community improvements within their own backyards. These securities are also easily accessible and scalable.

Exhibit 2



Source: World Economic Forum

[3]US SIF Foundation's 2016 *Report on Sustainable and Responsible Investing Trends in the US*, as of November 2016.
[4]ESG strategies largely absent from ETF landscape, by Ari I. Weinberg, January 26, 2015, pionline.com.

Public Equity: More and more publicly traded companies are taking a closer look at how they can improve their corporate citizenship ratings while incorporating ESG considerations into their daily business operations. While all public companies must maintain a traditional focus on profits, it is within their power to ensure that profits are not being generated at any cost. The question is how investors gage the extent of a company's sustainability and engagement. While it may be tempting to consider only easily quantifiable metrics such as corporate citizenship ratings or UN PRI signatures, such metrics are not a good proxy for decisions by an active investment manager. Many methodologies are currently being developed to rate companies based on their disclosure of quantitative and policy-related ESG data; this will help to improve the transparency of investments within this asset class but at present it is not enough to help investors make responsible decisions. Due to the high number of public equity securities and the amount of ESG-related corporate data in existence, nuanced judgment calls are required in order to determine what is "good" or "bad" from an ESG perspective. Investors should turn to active managers, who can develop an integrated ESG investment approach and engagement program, to make these decisions due to the mainly "grey" area that exists within responsible investments generally and publicly traded equity securities specifically.

Mutual Funds: Mutual funds are one of the most popular products within the RI space. The exciting thing about this vehicle is that it gives all types of investors access to RI in a much more powerful way. If desired, investors may fully allocate their investment dollars across asset classes using only mutual funds. RI mutual funds of all shapes and colors are growing at fast rate, and can be seen most evidently in the rise in the number of fossil-free and 'green' mutual funds. While there is limited customization opportunity within mutual funds, investors favor them for their transparency and ease of use, not to mention the vast array of options available to investors of all means. According to the US SIF, "mutual funds are one of the most dynamic segments within the environmental, social and governance (ESG) investing space." According to US SIF's most recent report done in November 2016, there were 475 ESG related mutual funds in the United States with assets of $1.72 trillion, representing the largest number of ESG funds and highest level of retail ESG fund assets relative to other investment fund types, including variable annuities, ETFs, closed-end funds and other pooled products.[3]

- Exchange Traded Funds: ETFs offer RI investors a passive approach to impact investing. In general, index-linked investments such as ETFs and index funds are well suited to investment approaches that utilize screens, both positive and negative, such as RI funds. RI-focused ETFs are not as numerous as those in other asset classes, representing less than 1% of assets in this category, but the number of options continues to grow steadily.[4] However, it is worth noting that engagement is a large and important part of investing responsibly. One key disadvantage of ETFs is that passive investments such as these cannot meaningfully engage with company management the way that active managers and investors can. Hence, the responsible investor interested in powerful imact may opt for different types of vehicles.

Alternatives: There are several different categories of alternative investments that RI investors may consider. These range from real assets including land and property to more esoteric private equity holdings. The issue that many investors face when considering alternatives is that they require more expertise and due diligence than publicly traded impact investments. They also may be more illiquid than other options discussed previously. However, a good starting point for investors to consider within this asset class is a liquid alternative, such as a commodity mutual fund or a publicly traded REIT fund.

- Private Equity: Private equity is one of the most frequently used instruments by responsible investors, particularly impact investors. Private equity and so-called 'angel' investors were some of the first to give credence to impact investing. According to Susan Balloch of the Global Impact Investing Network (GIIN), private equity is well suited to the impact investing industry in that it supports a vast array of different industries and also because it "is designed to maximize value and manage with efficiency."[5]
- Private Real Estate: This includes investments made through private placements into low-income housing, green buildings or architecture, sustainably managed properties, community development (charter schools, health clinics) and commercial space. Housing is one of the most popular sectors that impact investors allocate their funds to, according to the GIIN 2016 survey.
- Other Real Assets: Investments into land used for activities such as forestry, agriculture, water and food waste recycling are also considered to be RI. More options here would include investments made into infrastructure and buildings or facilities such as dams, wind turbines, clean water filtration and solar panels that serve to grow and stabilize the economies that they support.

[5]How Private Equity is Heeding the Call of Impact Investing, by Susan Balloch, March 8, 2016, institutionalinvestor.com.

Evidence of Growth

RI started out as a niche market with a small group of investors focused on the opportunity; however, interest has grown in both the number and types of investors who want to do "good" with their money. As a result of heightened demand, asset managers are directing more attention and resources towards generating supply. This has created a broad range of options available to investors that allow them to craft fully diversified portfolios with an ESG/impact focus on their own if so desired. However investors do not have to go it alone. The increase in demand has generated a large upturn in the number of professionally-managed products dedicated to ESG, impact and responsible investing.

In fact, Exhibit 3 illustrates that the growth in the number of ESG-related investment options over a span of three years approximates 22%.

Exhibit 3
Growth in ESG-Related Investment Options

	# of Funds at 12.31.13	AUM $million at 12.31.13	# of Funds at 3.31.17	AUM $million at 3.31.17	Product Growth	AUM Growth
Equity	106	121,210.50	130	164,716.30		
Fixed Income	27	15,220.80	32	14,765.00		
Total	**133**	**136,431.30**	**162**	**179,481.30**	22%	32%

Source: Morningstar Direct as of 5.1.17[6]

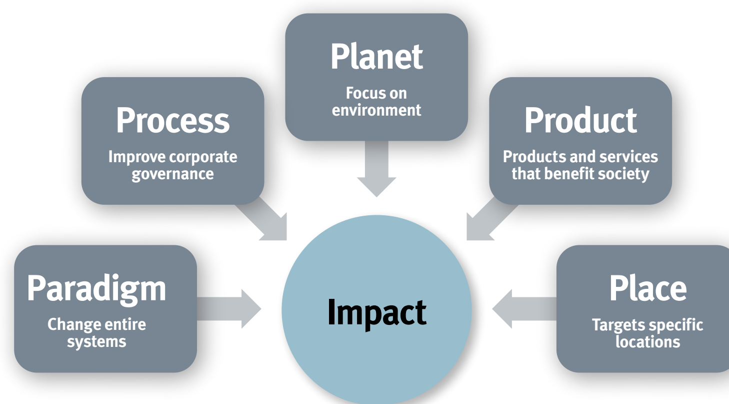
[6]Methodology: Non-surviving investments were included in this data; filter used in Morningstar to determine ESG funds was "Ethical Issue Strategy Focus – ESG Focus;" only US-domiciled, USD-denominated funds are included; only fixed-income and equity funds were included as represented by the "Global Broad Category Group;" only funds with assets in them were included.

Additional Ways to Diversify Through RI

Asset allocation is just one method that can be employed to diversify an ESG/impact-focused portfolio. As the popularity of responsible investing continues to grow, additional ways to diversify a portfolio through ESG/impact securities have been revealed.

Option: Diversify by type of impact
Every responsible investor has their own idea of what a "responsible" investment looks like. One investor may have a goal of improving low-income housing in inner cities. Another may want to support sustainable farming in Africa. Or women's issues. Or cancer. There are so many different types of impact investments that it has become difficult for investors to categorize or classify them in a consistent manner. One of the simpler solutions to the question of classification was developed in an article published by the Harvard Business Review.[7] The article outlines five categories of impact investments: place, planet, product, paradigm and process. Using this tool, an investor can indentify options in each of the five categories and diversify their portfolio by impact type.

Exhibit 4



Source: Harvard Business Review

Option: Diversify by risk/return profile
Another option is for investors to diverify their portfolio according to the risk/return profiles of their holdings. Risk is always a factor to consider in every investment, but it is two-fold in responsible investments. Investors are faced with both performance and social/impact risk. Every RI investor seeks to achieve the "double bottom line" with their investments. While broad performance and risk measurement standards have been in place within the investment industry for decades, the concept of measuring social impact risk is merely nascent and is a source of many questions from investors. For example, how do you measure an investment's social impact when each investment may vary in its intent and purpose? This two-fold risk is just one factor that may prevent RI investments from attracting the investments necessary to achieve scale.

However, there may be a way around this by merely modifying standard measurement methods that are already in place.

Given the growth in the field of responsible investing, there are many organizations looking to measure both the financial and social/impact risks of investments and securities. Each one takes a very different approach based on their own organizational philosophy and the needs of their clients. For example, iPAR, a patent pending platform developed by The CAPROCK Group, measures impact performance and risk attributes that can be applied to any impact investment regardless of its asset class or vehicle structure. Another example is the Heron Foundation, a grantmaker and mission investor focused on reducing poverty. This organization is building an operational model that includes metrics on both the financial and social outcomes of their investments simultaneously. As time progresses, many more options for measuring the impact of responsible investments will inevitably become available. It will be up to the investor to determine which methodology is most applicable to their objectives and goals.

[7]Making Sense of the Many Kinds of Impact Investing, by Brian Trelstad, January 28, 2016, Harvard Business Review.

Conclusion

The field of RI investing has grown so significantly that it is now possible for investors to craft a fully diversified portfolio of responsible investments without lowering financial performance expectations. Stakeholders' interest in investing according to their values has created an entire infrastructure of support that has made RI investments easier to access. While there remain hurdles to overcome, it is our opinion that they will be overcome in the near future as demand continues to grow and the industry adjusts to need. However, one of the most difficult changes that needs to occur is that of the perception of responsible investing. RI investing is not an asset class—it is a way of thinking about the power of the dollars that investors control. It is "…a paradigm shift in how our world thinks about the interaction between markets and societal benefit."[8] Today, through their portfolios, investors can achieve diversification and impact simultaneously. An investment of any size has the capacity to improve communities and those that live within them. This is by definition, a paradigm shift.

[8]Source: unreasonable.is by Ross Baird

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