TRUST MANAGEMENT

Standing with you to deliver community good.

INVESTMENT PROPERTY ACCOUNTING

Guide to Ethical Investing for Charitable Trusts

March 2025

Doing well to maximise good.

Contents

Published on 28 March 2025

Understanding Key Terms

In order to have informed conversations about ethical investing, it is important to understand and distinguish between the key terms of Responsible Investing ('RI'), Socially Responsible Investments ('SRI'), and Impact Investments ('II').

Each of these terms reflect investments that consider environmental, social and governance (ESG) factors in some way. For ease of use and understanding, all of these investment terms are referred to collectively as 'ethical investing'.

The following section helps readers to understand and distinguish the key investment terms, and serves as a basis to inform discussions throughout this document.

Overall, this guide aims to help Trustees consider and evaluate how they can prudently introduce elements of ethical investment into their investment portfolios.

What is Responsible Investing (RI)?

The United Nations (UN) supported Principles for Responsible Investment initiative ("PRI") is one of the world's leading proponents of responsible investment.

PRI defines Responsible Investment (RI) as 'an approach to investing that aims to incorporate environmental, social and governance (ESG) factors into investment decisions, to better manage risk and generate sustainable, long-term returns.'

Is RI the same as Socially Responsible Investment (SRI) or Impact Investing (II)?

Not entirely.

In touching on themes including environmental issues, social issues, and sustainability, responsible investment does have similarities with such investment approaches as:

- socially responsible investing (SRI)
- Impact investing (II)
- sustainable investment
- ethical investment
- green investment

Crucially, however, while these approaches seek to combine financial return with a moral or ethical return, responsible investment can and should be pursued even by the investor whose sole purpose is financial return, because to ignore ESG considerations is to ignore risks and opportunities that could have a material effect on investment returns.

Additionally, many of these investment approaches can target specific themes, such as focusing solely on environmental issues, whereas responsible investment is a more holistic approach that aims to include any information that could be material to investment performance.

Labelling of investments can be confusing and misleading. The distinctions are not always clear, and there can be unsubstantiated claims about investments being responsible or impact for marketing purposes. It is important to look at the evidence to check whether the claims are justified.

Is responsible investment about screening and divestment?

Responsible investing may not necessarily mean adopting a blanket approach to ruling out investment in any specific sector or company.

It simply involves reflecting ESG considerations into the investment decision-making process, to ensure that all relevant factors are accounted for when assessing both risk and return.

Exactly how an investor practices responsible investment varies widely. It can include:

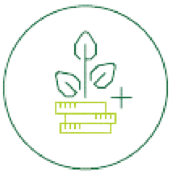
- integrating ESG information into quantitative and qualitative analysis, and making adjustments to areas such as investment or stock selection, securities weightings or asset allocation;
- engaging – either individually or alongside other investors – with investee companies/entities on the ESG issues or concerns;
- using shareholder voting rights to influence company behaviour;
- encouraging investee companies/entities to disclose information on the ESG issues that do or could affect their business;
- monitoring overall ESG risk within the portfolio, for instance by measuring the portfolio's carbon footprint and working to reduce it;
- contributing to the shaping of investor-relevant public policy;
- promoting wider acceptance and use of responsible investment.

Does practising responsible investment mean using themed funds and green bonds?

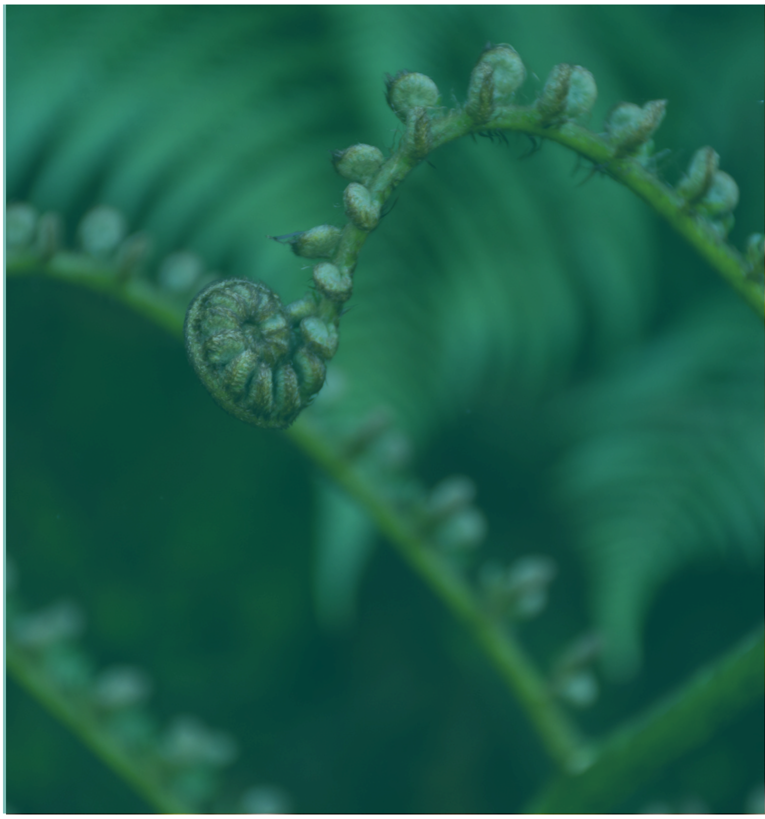
Responsible investment may not necessarily require the use of specialised products. Responsible investment can be applied to a portfolio through integrating additional data and analysis into an existing approach.

Tailored products whose remit overlaps with areas of responsible investment do exist and have grown in popularity in recent years. Such funds include environmentally or socially-themed funds, green bonds or social impact bonds. All of these types of products can form part of a responsible investment strategy.

Responsible investment does not require a blanket approach to ruling out investment in any specific sector or company.



What is Socially Responsible Investment (SRI)?



Socially Responsible Investment ('SRI') strategies tend to combine both financial return objectives, alongside the social and environmental impacts of the investment; most often with the objective to limit harm.

Socially responsible investments focus on ESG issues and often involve either screened products (commonly referred to as "negative screens"), or focused investment (referred to as "positive screens", such as themed exchange traded funds, ETFs).

In practice, a large number of funds use both RI and SRI techniques. Most funds classified as RI will employ some form of negative screens (for example, most New Zealand funds exclude tobacco and controversial weapons). A growing number of funds may also incorporate SRI considerations in their settings, with negative screens focused on social issues such as human rights violations.

What is Impact Investing (II)?

Impact investing strategies have a focus on delivering outcomes that produce positive social and/or environmental impact.

A commonly used definition is: "Impact investments are investments made with the intention to generate positive, measurable social and environmental impact alongside a financial return."

This puts the emphasis on the intentionality, the measurable impact, and the aim to provide both positive impact and financial return.

The category is growing. It had its roots in the venture capital community and included investments in microfinance, community development finance, and clean technology.

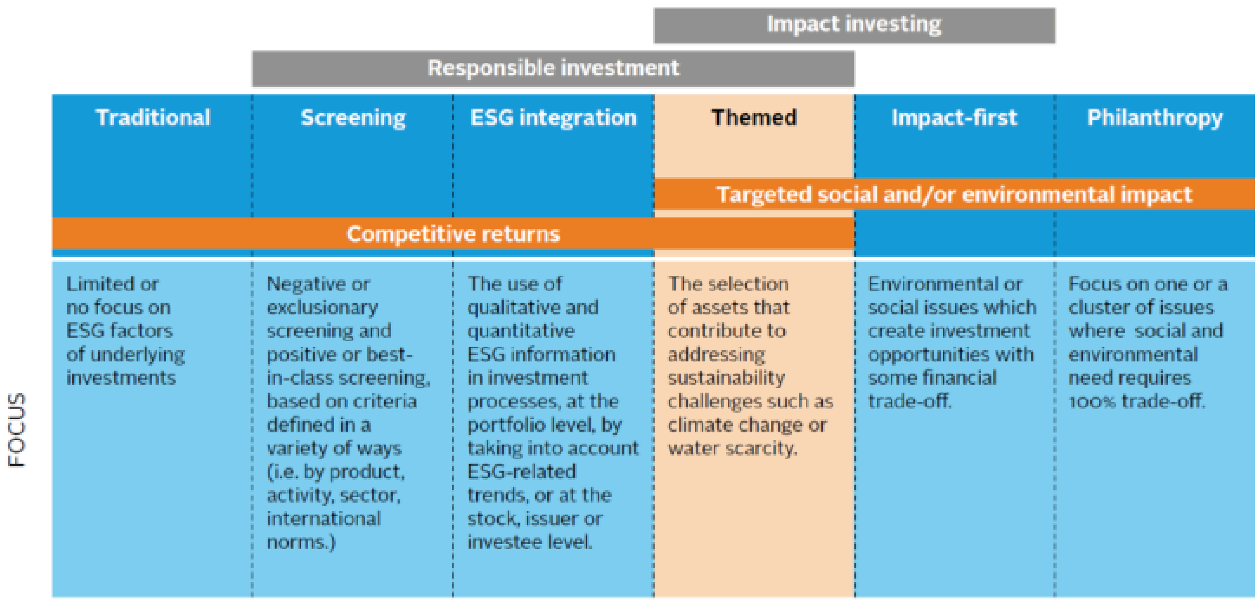
Which is best?

A recommended approach to how trustees could consider adopting Responsible Investment, Socially Responsible Investment and Impact Investment approaches is outlined below and shown graphically;

Responsible Investment is the conscious decision to consider ESG issues when evaluating investment options. Our view is that all investors should be responsible investors. It is the duty of Directors and Trustees to consider all material risks in an investment portfolio, and ESG risks are no exception. To ignore ESG risks is akin to investing in Blockbuster Video and ignoring the impact of the internet on that business.

Socially Responsible (including Themed) Investment aims to generate financial returns while also making a positive impact on society. Themed investing focuses on specific sectors, trends, or themes that are expected to grow and perform well over time, allowing investors to align their portfolios with their interests or beliefs. SRI investing can be most effective when it is undertaken as part of a coordinated campaign, and on a large scale. SRI investing often reflects the preferences of the asset owners. When surveyed, most New Zealanders don't want their funds to be invested in companies that produce weapons or violate human rights or profit from gambling. The most obvious approach is not to invest in those sectors or types of companies.

Impact Investing tends to have a stronger focus on social and environmental outcomes and by nature of the offerings, is often more local than macro level focussed and may be higher risk, at least until there is more experience with the investment category. Typically, where there is a strong rationale for impact investment, an allocation may be made as a higher-risk category within a larger portfolio. Where impact investments align with charitable purpose, provided risks and returns are appropriate, impact investments can 'double the bang for your buck'.



Source: PRI

Can trustees prudently invest in an ethical manner?

In short, yes, absolutely.

However, Trustees must exercise caution in the way they invest to ensure they do so prudently and in accordance with their fiduciary duties. For example, a decision not to invest in a high-carbon asset because of financial concerns about stranded assets is likely to be seen as consistent with fiduciary duty, providing that the decision is based on credible assumptions and robust processes.

The following sections outline the framework under which Trustees can invest in ethical investments, and how interactions with the Trust Deed would apply.

Trustees must exercise caution in the way they invest to ensure they do so prudently and in accordance with their fiduciary duties.

Duty to charitable purpose

Trustees are likely already aware of their fiduciary duty to the charity and are often worried an investment into an ethical fund, or taking ESG matters into consideration when investing, will impinge on their duty to act prudently.

Trustees duty to the charitable purpose is paramount, however that does not mean that a Trust cannot make ethical investments. Instead, investing in accordance with responsible investment principles actually demonstrates prudence and fulfils trustees' fiduciary duties.

People who assert that charities cannot make ethical investments without compromising their charitable purpose often ignore two important aspects, which we discuss further in the following sections;

- An ethical investment does not have to result in a suboptimal return;
- If the ethical criteria of a fund is aligned with the charitable purpose, then Trustees can make the active decision to accept suboptimal returns in furtherance of their charitable purpose.

Does ethical investment equate to suboptimal investment?

It doesn't need to.

An intrinsic relationship between ethical investing and suboptimal returns is one of the biggest myths associated with ethical investing. There are many ethical investments that provide market returns with market risk profiles.

There is extensive evidence to show that ethical investing can earn returns that are, on average, at least as high as traditional investing (priving fees are reasnable). Global index and research company, MSCI, recently published research showing that companies with better ESG practices generated materially stronger returns for their shareholders than those with worse ones over the long term.

However, that is not to say, all ethical investment funds or techniques represent good investments. As with any investment, it is essential to conduct your due diligence to determine the expected return and volatility of an investment.

Investments that are aligned with charitable purpose

If your charity has a very broad charitable purpose, or if you identify an ethical investment fund that has ethical criteria aligned with your charitable purpose, you may have some more flexibility and options when it comes to ethical investments. In such situations, a fund with ethical criteria that is aligned to the Trust's purpose, but may be achieving suboptimal returns, could still be a suitable investment strategy.

At this point, there are two aspects to clarify: the first is what we mean by 'suboptimal' and the second is when Trustees should exercise some caution.

Share price performance of companies with the highest vs. lowest MSCI ESG Ratings in the MSCI AC Asia Pacific Index

The graph above shows that companies were in the top 20% of MSCI ESG Ratings for the MSCI AC Asia Pacific Index performed significantly stronger than the bottom 20% from January 2013 to December 2023. This was similar for those companies on the individual pillars also, particularly on Governance characteristics.

Source: https://www.msci.com/www/blog-posts/long-term-performance-of-msci/04531705362

Kia mau ki te tokanganui a nobo.

There is no place like home.

What is suboptimal?

Suboptimal returns are often misunderstood as losses or significantly lower returns, but they actually refer to returns that are below the market average. Market returns themselves can vary, so the benchmark return for an asset class is typically used as a reference point.

When evaluating investment markets and asset class returns, it's important to remember that benchmark returns are gross returns. This means that even in a large passive index-tracking share fund, fees and costs will affect your net returns.

All funds charge fees, so you might wonder when the fees of an ethical fund become suboptimal. Ethical funds often have slightly higher management fees, though not always. To determine if a higher management fee makes a fund suboptimal, consider the standard deviation of market returns, market fees, and the relative impact of the fee premium on your expected return.

For example, if you expect a long-term return of 7% from global equities, with returns ranging between 6% and 8% for 68% of the time, and market fees for an index-tracking fund are around 0.5% to 0.75%, then a 5 to 10 basis point (bps) fee premium for an ethical fund with similar return and volatility characteristics is unlikely to result in suboptimal returns. However, a management fee of 1.5% would likely lead to suboptimal financial returns compared to full market exposure.

Evaluating investments beyond financial return

An argument we often hear is that Trustees should evaluate investments beyond financial return and volatility, and look at the bigger picture of the ethical and social outcomes of their investment portfolios. It is understandable that Trustees of charities who are passionate about positive social change would have this viewpoint, however, it does need to be considered in the context of two points we have already discussed.

Firstly, this is an argument often raised when a charity wants to invest in an ethical investment that is expected to provide suboptimal returns. However, as noted earlier, there are products in the market that will provide ESG elements at market returns, and within the range of market prices.

Secondly, where such investments are aligned with the charity’s purpose, Trustees can decide to accept a lower potential financial return in the future, acknowledging the bigger picture.

However, the argument often arises when the charity has a specific purpose and the ethical investment fund the trustees want to invest in is not aligned to this purpose. For example, this could apply where Trustees of a charity, whose purpose is for education, wish to invest in a social housing initiative that will yield below-market returns with higher risk and costs.

Our perspective is that the primary responsibility of Trustees is to uphold their charitable mission. This does not restrict Trustees to only basic investment choices; rather, they should seek out ethical and responsible investment funds that are likely to deliver market returns at a reasonable cost.

Furthermore, Trustees can incorporate responsible investment principles when assessing investment options and assigning weight to positive ESG outcomes. However, we advise Trustees to be cautious about placing excessive emphasis on these objectives over traditional considerations such as return, risk, and price. Trustees must act prudently, ensuring that their approach to responsible investment is balanced with the advancement of the charity's mission.

When to exercise caution

We have observed situations where Trustees choose to invest in a product or fund due to its alignment with their charitable purpose, sometimes neglecting adequate due diligence. Trustees may enter into such investments with overly optimistic expectations, reassured by the alignment or authority within their Deed to make these investments.

For instance, a community trust might decide to provide loans to local businesses, aligning well with their charitable purpose. However, without proper due diligence, the risks of the investment, such as credit default, may not be fully understood.

If the loans default, Trustees have essentially made a distribution rather than an investment, with the decision being dictated by the prevailing circumstances. Often, both Trustees and the community perceive this as a failed investment and a governance failure, regardless of the authority granted under the Deed.

In our view, the scenario described above represents a governance failure when distribution decisions are made by default.

When a charity enters into an investment aligned with its Deed, that has elements of risk or an expectation that not all capital will be recovered, then Trustees should be aware of whether they are effectively making a decision to invest or distribute.

If Trustees are comfortable that, even if the loan or investment fails, it was still a worthwhile endeavor, then the investment can proceed.

Trustees are essentially deciding to distribute, via a loan, with the possibility of recovering that loan/distribution to be reapplied to the charity's purpose.

The decision to invest in an asset that may become a distribution should be carefully considered and factored into the charity's overall distribution strategy, ensuring that a default will not unduly impact the Trust's overall position.

Ethical Investing throughout the whole investment process

The following section is a guideline on how your charity can incorporate responsible investing and ethical investing at every stage of your investment decision-making process.

Defining your ethical criteria

It is helpful for Trustees to have a conversation about the ethical criteria in which they wish to evaluate their investments, much in the same way as it can be useful for Trustees to form a Statement of Investment Beliefs. By setting out the ethical criteria which is of particular concern to Trustees, the investment process can be informed by these criteria, ensuring incorporation to the appropriate extent throughout the investment process.

Defining the ethical criteria can also determine which ethical concerns have a stronger weighting than others. For example, if your charitable purpose is concerned with protecting the environment, then matters such as pollution and climate change will be of most significant concern. However, Trustees may also wish to avoid investments in tobacco, perhaps not entirely due to environmental concerns, but also because of the medical implications on its consumers and the cost to the economy from the negative externalities of tobacco use.

When evaluating investments, the weighting of different ethical criteria will assist trustees, beneficiary's investment advisors and other associated parties in understanding the reasoning behind the Trusts' investment strategy.

Statement of Investment Policies and Objectives (SIPO)

It is best practice for a Trust to have a SIPO ('Statement of Investment Policies and Objectives') in place, which outlines the Trust's investment objectives, sets out the collective investment principles/beliefs of Trustees, and outlines the investment strategy to achieve the Trust's objectives.

This may include guidance as to which asset classes will form part of the Trust's investment portfolio, as well as the management style of those asset classes, and benchmarks for each asset class. The SIPO will include a statement as to the Trustees' appetite for risk.

When incorporating ethical and responsible investment considerations into the SIPO, Trustees should consider how long-term trends may affect their portfolios (i.e. stranded assets), alignment of investment portfolio with charitable purposes, as well as defining the Trust's approach to responsible investment. For example, 'Do Trustees view ESG factors as material?' 'What is the Trust's ethical investing policy?' 'Are investments evaluated purely on financial return and volatility, or are real-world impacts considered as well?'

Asset allocation

Responsible Investing can impact asset allocation decisions.

Asset allocation decisions are traditionally driven by three main variables: asset class return, asset class volatility, and asset class correlation.

A typical asset allocation process will involve reviewing the base asset class assumptions, generating various portfolio scenario's and testing Trustees' risk appetite, as they seek to balance the rewards and risks of each portfolio.

An important aspect of asset allocation scenario modelling, which is often missed by advisors to the charitable sector, is the income/capital split of the expected portfolios and the impact on volatility of growth compared with income-focused portfolios.

When Responsible and Ethical Investing preferences are added into asset allocation considerations, the ability of various asset classes to incorporate the Trust's ethical investment policies becomes a further variable to consider in portfolio modelling.

Selecting and appointing fund managers

A traditional manager selection process looks at various factors such as:

1. Fund returns over various time series
2. Fund volatility over various time series
3. Management style, indexed versus active, growth versus defensive
4. People, those individuals driving the investment decisions
5. Process, stock selection processes, investment methodology
6. Fees, including fee structures, and fund expenses.

When appointing fund managers within a Trust's portfolio, it is best practice to integrate ESG considerations into the due diligence and appointment process. For example, evaluating how your investment managers incorporate ESG factors into their decision-making; do they use ESG as a negative screen, or do they integrate ESG considerations throughout their investment process? Additionally, assess whether the fund manager actively engages on ESG issues.

A practical starting point for evaluating a fund manager's ESG credentials and process is to verify if they are signatories to the PRI or a member of the Responsible Investing Association of Australasia and to request copies of their RI / Ethical Investment Policy.

A good place to start when evaluating a fund manager's ESG qualities is to check whether they are signatories to the PRI.

Ongoing monitoring and evaluation.

The investment process should consider how the Trust will continue to monitor ESG risks and matters within the investment portfolio on an ongoing basis.

Trustees might wish to periodically re-evaluate their ethical investment policy, review their ESG focus points, and evaluate the real-world effectiveness of the ESG elements of the investment portfolio.

Making the ethical policy available

Trustees may also consider making available a separate policy on ethical investing that sets out the rationale for the policy and its key elements.

This may include a list of exclusions, how ESG factors are analysed, how ESG considerations are incorporated into portfolio selection and management, and any provisions for engagement with companies, including through third parties.

Where to learn more

Speak to us at Trust Management

Established in 2001, Trust Management believe in a worldview of protecting and enhancing people, land and culture. Ethical investing has been our entire focus since we were formed.

As a registered charity ourselves, we have a very clear driver: to align with our clients' needs, purposefully managing funds that create the most good while building sound financial returns.

We have assisted and guided a number of charities through the process of incorporating ESG matters into their investment portfolios and developing ethical investment policies.

Trust Management advises on over $1.6b of investment assets and offers a range of Investment PIE Funds which all have elements of ESG criteria.

Recognition

2023 INFINZ AWARDS — Chapman Tripp Diversified Growth Fund Manager of the Year FINALIST

PROPERTY INSTITUTE AWARDS 2023 — WINNER PROFESSIONAL BUSINESS OF THE YEAR

Member

Property Council New Zealand

PRI

NZGBC TE KAUNIHERA HANGANGA TAUTAIAO

riaa

STEWARDSHIP CODE AOTEAROA NEW ZEALAND

Philanthropy New Zealand Tōpūtanga Tuku Aroha o Aotearoa

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INVESTMENTS + PROPERTY + ACCOUNTING

Please reach out to Halie or Matthew if you would like further information on our ethical investment approach.

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