TRUST MANAGEMENT

A Guide to Ethical Investing for Charitable Trusts

November 2020

A Guide to Ethical Investing for Charitable Trusts

Contents

Understanding the Key Terms **2**

What is Responsible Investing (RI)? 2

What is Socially Responsible Investment (SRI)? 3

What is Impact Investing (II)? 3

Which is best? 4

Can Trustees Prudently Invest in an Ethical Manner? **5**

Duty to charitable purpose 5

Does ethical investment equate to suboptimal investment? 5

Investments that are aligned with charitable purpose 5

Evaluating investments beyond financial return 6

When to exercise caution 7

Ethical Investing throughout the whole Investment Process **8**

Defining your ethical criteria 8

Statement of Investment Policies and Objectives (SIPO) 8

Asset allocation 8

Selecting and appointing managers 9

Ongoing monitoring and evaluation 9

Where to learn more **10**

Speak to us at Trust Management 10

Understanding the 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. The way in which ESG matters are considered is what differentiates these alternative types of investment. However, 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 portfolios.

What is Responsible Investing (RI)?
The United Nations (UN) Principles for Responsible Investment initiative ("PRI") is the world's leading proponent 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)?
No. 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 it argues that to ignore ESG factors is to ignore risks and opportunities that have a material effect on the returns delivered to clients and beneficiaries.

Also, many of these investment approaches target specific themes, such as focusing solely on environmental issues, whereas responsible investment is a 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 are 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, including whether or not there are credible forms of certification.

Is responsible investment about screening and divestment?

Responsible investment does not require a blanket approach to ruling out investment in any specific sector or company. It simply involves reflecting ESG information in investment decision-making, 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 selection, weighting or asset allocation;
- engaging – either individually or alongside other investors – with investee companies/entities on the ESG factors identified as relevant to them;
- using shareholder voting rights to influence company behaviour;
- encouraging investee companies/entities to disclose information on the ESG factors that do or could affect them;
- 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 does not require the use of specialised products. It is primarily about integrating additional data and analysis into existing approaches. Tailored products whose remit overlaps with areas of responsible investment do exist, such as environmentally- or socially-themed funds, green bonds or social impact bonds, and these can form part of a responsible investment strategy.

What is Socially Responsible Investment (SRI)?

Socially Responsible Investment ('SRI') is any investment strategy which seeks to consider both financial return and the social and environmental impacts of the investment, most commonly to limit harm. Socially responsible investments focus on environment, social or corporate governance issues ('ESG') and typically involve either screened products (sometimes called negative screens), or focused investment (sometimes called positive screens, such as themed exchange traded funds, ETFs).

In practice, a large number of funds use both RI and SRI. Most RI has some exclusions (for example, most

New Zealand funds exclude tobacco and controversial weapons) and a growing number of SRI funds include ESG management, particularly on issues such as human rights.

What is Impact Investing (II)?

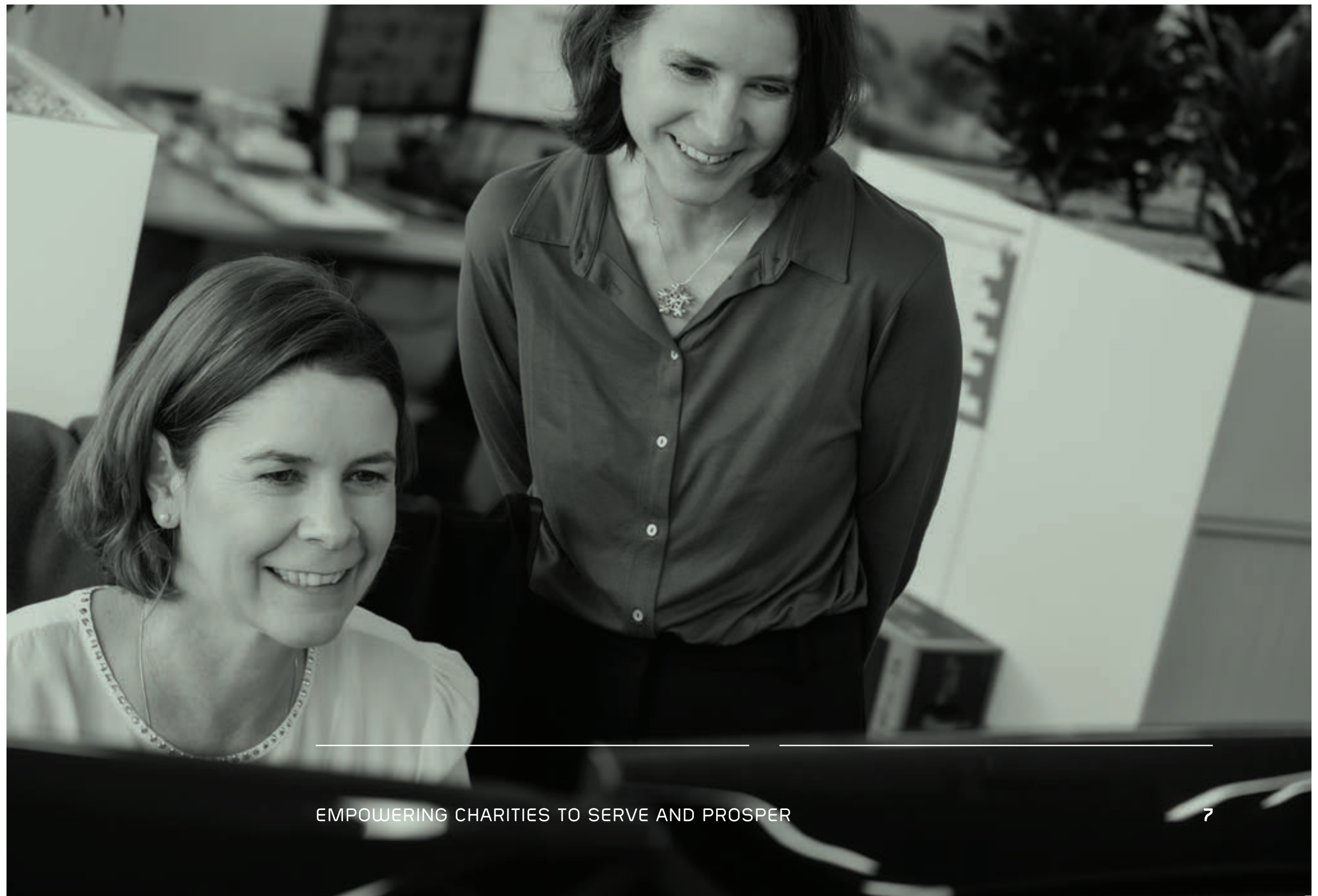
Impact investing has a focus on producing positive social and/or environmental impacts. The most commonly-used definition is "Impact investments are investments made with the intention to generate positive, measurable social and environmental impact alongside a financial return." This puts the emphasis on the intentionality, the measurable impact and the aim to provide both positive impact and financial return.

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

Which is best?

The way we recommend you think about Responsible Investment, Socially Responsible Investment and Impact Investment is as follows:

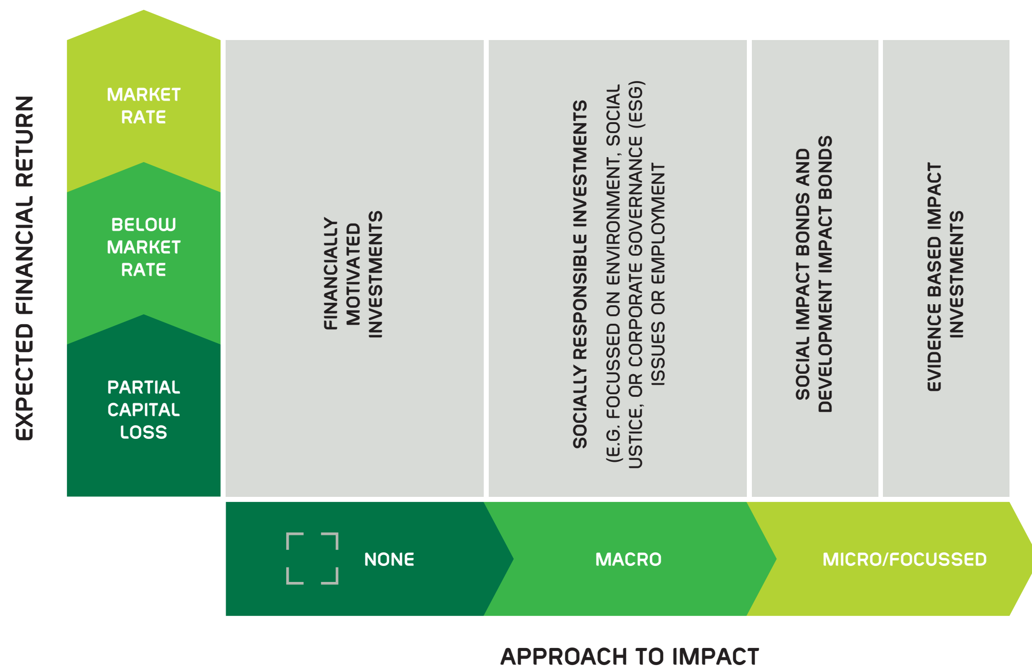
Responsible Investment is the conscious decision to consider ESG issues when evaluating investment options. We advocate that all investors should be responsible investors. It is the duty of Directors and Trustees to consider all material risks, and ESG risks are no exception. To ignore the ESG issues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



Socially Responsible Investment is most effective when it is undertaken as part of a coordinated campaign, with outcomes at the macro level. When excluding and divesting of companies with low ESG scores at sufficient scale, the cost of capital increases and signals are sent through the market. For many ESG issues, the greatest impact can occur at the macro level rather than the micro level. For example, an ESG issue like gender balance on governance boards can be effectively promoted through SRI placing the spotlight on the issue across all sectors (such as through the transfer of $100b of capital into an EFT that excluded governance boards with no female representation).

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 is likely to 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'.



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 duties, 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.

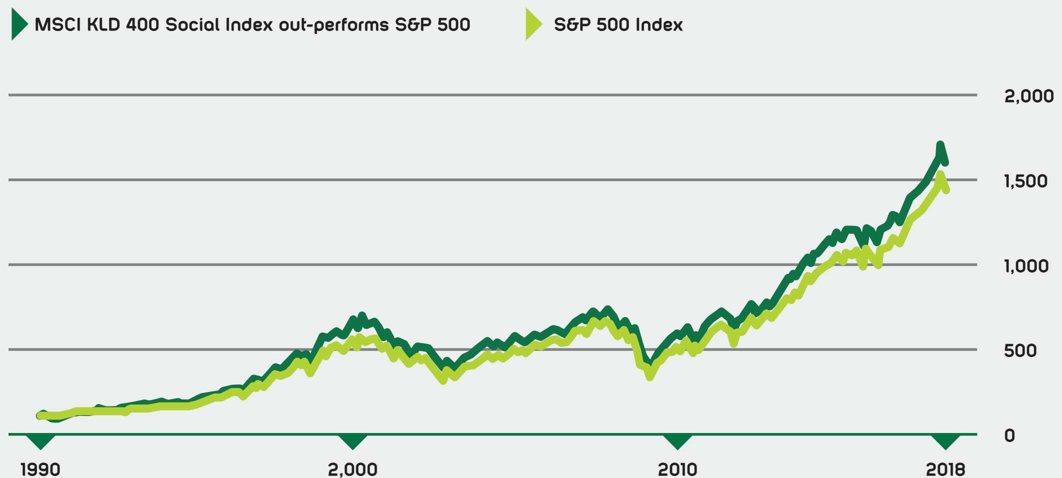
Duty to charitable purpose
Trustees are likely already aware of their fiduciary duty to the charity and are often worried an investment into an ethical fund, or taking ESG matters into consideration when investing, will impinge on their duty to act prudently.

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;

(1) an ethical investment does not have to result in a suboptimal return;
(2) 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.

MSCI KLD 400 Social Index out-performs S&P 500 / 1990 - 2018



Sources: MSCI, S&P
Note: Indexed to 100

Does ethical investment equate to suboptimal investment?

No. An intrinsic relationship between ethical investing and suboptimal returns is one of the biggest myths associated with ethical investing. There are many ethical investments which provide market returns with market risk profiles. Investing in ethical investments does not mean investors need to accept suboptimal returns. There is extensive evidence to show that ethical investing earns returns are, on average, at least as high as traditional investing. However, that is not to say, any ethical investment is a good investment. As with any investment, it is essential to conduct your own 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 which 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 which is aligned to your 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.

The definition of suboptimal is less than optimal, or less than perfect, however many people associate suboptimal returns with a loss of capital or drastically lower returns. In reality, suboptimal is a range, and in this context, we refer to suboptimal returns as those returns which are expected to be below market returns. Inevitably, market returns also have some variability as well, so we typically talk about the market return as being the benchmark return for that asset class.

When considering investment markets and asset class returns, it is also important to note that the benchmark returns are gross returns, so even if you are investing into a large passive index tracking share fund, there will be some fees and costs which will impact your net return.

Given all funds charge some sort of fee, you may ask at what point do the fees of an ethical fund become suboptimal? In many instances, ethical funds will have a slightly higher management fee, though not always. When assessing whether the higher management fee will result in the fund being suboptimal, it is useful to think about the standard deviation of the market return, the market fees, and apply some relativity to determine if the fee premium for an ethical product will negatively affect your expected return.

By way of example, if you are investing in global equities and have an expectation of a long run return of 7%, with a return between 6% and 8% for 68% of the time, and market fees for an index tracking fund are circa 50 - 75 basis points (0.5% - 0.75%), then a 5 to 10 basis points (bps) fee premium for an ethical fund which has the same return and volatility characteristics would be unlikely to result in suboptimal returns (the materiality of the fee difference is low). However, a management fee of 1.5% would most likely result in suboptimal financial returns compared to a 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 which 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 charities' purpose, Trustees can make the decision to accept a lower financial return, acknowledging the bigger picture. However, again 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 which will yield below market returns with higher risk and costs.

Our view is that the Trustees' first duty is to their charitable purpose. The advancement of education should not be compromised by investments which do not provide market returns. That does not mean Trustees are limited to purely vanilla investment options, they just need to seek out those ESG investments which expect to provide a market return at a reasonable cost. Also Trustees can practise responsible investment principles in evaluating investment options and attributing weighting to positive ESG outcomes, although we recommend Trustees exercise caution when too much weight is placed on these objectives above traditional weightings of key considerations including return, risk and price. Trustees have a duty to act prudently, which means the approach to responsible investment should be balanced with the advancement of the charities' purpose.

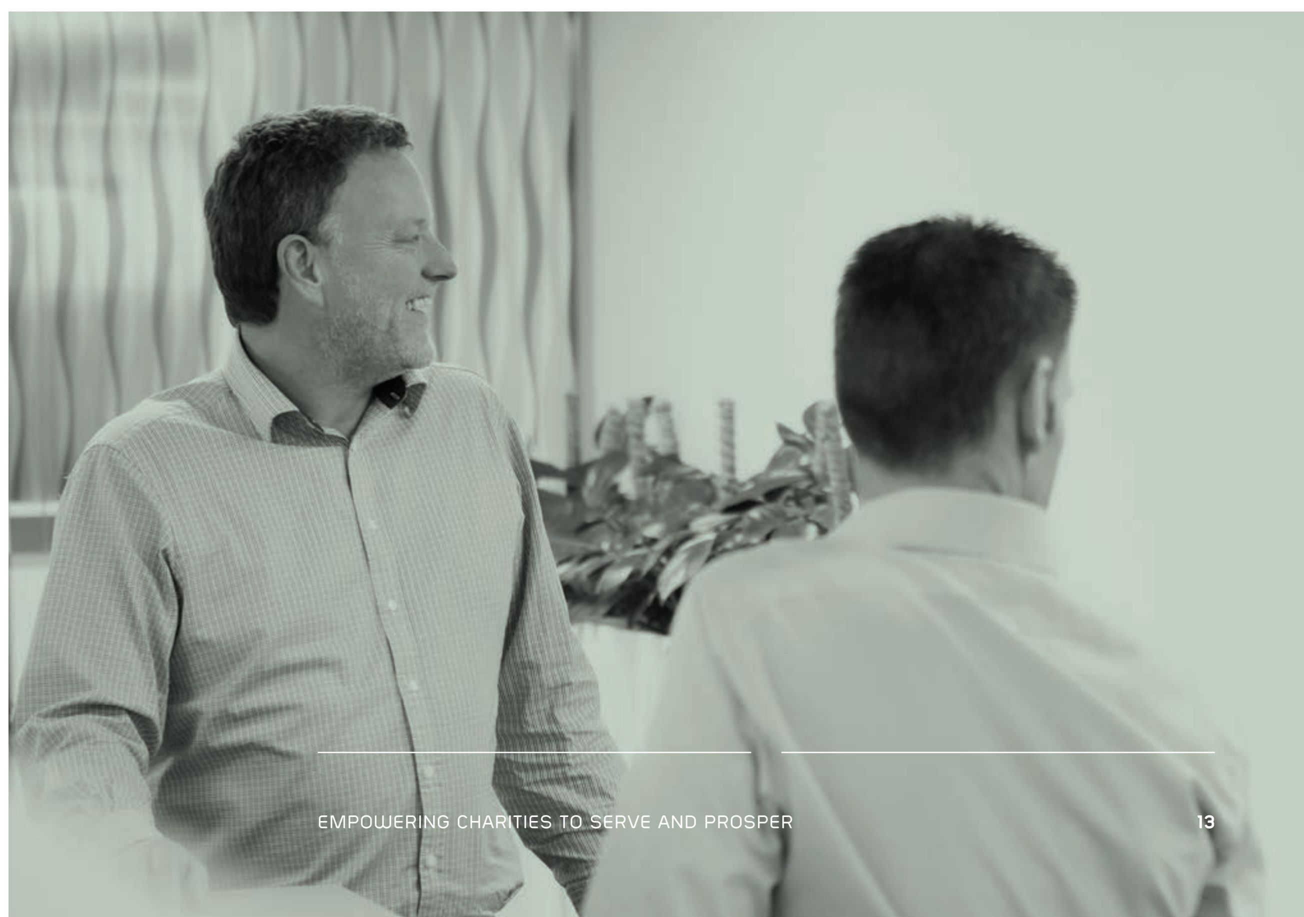
When to exercise caution

We have seen many instances where Trustees have opted to invest into a product or fund because of the alignment with their charitable purpose, sometimes forgoing appropriate levels of due diligence. Trustees may enter into such investments with overly optimistic expectations, comforted by the alignment or authority within their Deed to make such investments. For example, a community trust decides to provide loans to local businesses, as this provides good alignment to their charitable purpose. However, if there is not appropriate due diligence into such investments, the loans can default. When loans default, Trustees have effectively made a distribution rather than an investment, albeit the distribution decision was made for them, by the circumstances which prevailed. Often Trustees and the community see this as a failed investment and a failure of governance, regardless of the authority granted under the Deed.

Our view of the scenario played out above, is that it is indeed a failure of governance when distribution decisions are made by default. In such instances, where a charity is entering into an investment aligned to its Deed, which 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 in the event the loan or investment fails it was still a worthwhile endeavour, then the investment can proceed. Trustees are effectively making the decision to distribute, by way of loan, with the possibility of recovering that loan/distribution to be reapplied to the charities' purpose again. The decision to invest into an asset which may become a distribution, should be considered and have an impact, when the charity is making distributions from its reserves, returns, so that a default of the investment will not unduly impact the Trusts' position overall.

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 upon, 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 smoking.

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)

Trustees should have a SIPO ('Statement of Investment Policies and Objectives') which outlines the Trusts' investment objectives, sets out the collective investment principles/beliefs of Trustees, and outlines the investment strategy to achieve the Trusts' 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 responsible investment into the Trusts' 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 investment 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 off three main variables, asset class return, asset class volatility, and asset class correlation. A typical asset allocation process involves 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 focussed portfolios.

When Responsible Investing is added into the 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 managers

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

(i) Fund returns over various time series
(ii) Fund volatility over various time series
(iii) Management style, indexed versus active, growth versus defensive
(iv) People, those individuals driving the investment decisions
(v) Process, stock selection processes, investment methodology
(vi) Fees, including fee structures, and fund expenses.

ESG should be part of your investment process when considering and evaluating investment managers and investment funds. ESG should be considered with respect to the manager's investment process, including to what extent they take ESG considerations into account when selecting investments. For example, is ESG incorporated only as a negative screen, or does the Manager adopt an 'integration approach' to ESG in their investment process, and does the Manager undertake engagement specifically on ESG issues?

A good place to start when evaluating a Manager's ESG qualities is to check whether they are signatories to the UN Principles for Responsible Investing ("PRI").

Ongoing monitoring and evaluation.

Your investment process should consider how you will continue to monitor ESG risks and matters within your portfolio in 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

Trust Management are the only investment advisor and fund manager in New Zealand solely dedicated to working with charities. We have a long track record of successfully working with charities to provide stable returns and income for distribution. We have assisted and guided a number of charities through the process of incorporating ESG matters into their investment portfolios. Trust Management advises on over $1.5b of investment assets and offers six Investment PIE Funds which all have elements of ESG criteria and are only available to New Zealand registered charities.

Trust Management are signatories to the UN PRI. Further information about this initiative is available at www.unpri.org

www.trustmanagement.co.nz

TRUST MANAGEMENT

Location

Level 4, 123 Carlton Gore Road
Newmarket, Auckland, 1023
PO Box 37448, Parnell, Auckland 1151

Make contact

Freephone: 0800 550 4040
Telephone: 09 550 4040
info@trustmanagement.co.nz