

PRIME Toolkit

PRIMER FOR
RESPONSIBLE
INVESTMENT
MANAGEMENT OF
ENDOWMENTS



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This toolkit has been created in a partnership between The European Social Investment Forum (Eurosif), and the Bellagio Forum for Sustainable Development, in cooperation with the European Foundation Centre (EFC)

FOREWORD

Responsible Investing of Foundation Endowments

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This work is a joint effort between the Bellagio Forum, Eurosif and the European Foundation Centre, to build a Toolkit to help foundations manage their endowments in a socially responsible way. The need for a practical guide for foundation trustees emerged after the Bellagio Forum conducted a survey among European and some international foundations to map the current practices of investing and managing the foundations' endowments. What the survey revealed was an array of emerging experiences among European foundations with regard to their asset management strategies; however one clear need identified is for a resource to assist foundation trustees and executives to develop a greater understanding of and approach to the topic of responsible investment.

The aim of this guide is to provide more clarity and deeper understanding for all interested parties about how to better implement responsible investment practices. The Toolkit will serve not only endowed foundations, but also mainstream financial service providers interested in responsible investment.

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Regional Environmental Center for Central and Eastern Europe
Reuters Foundation
Rockefeller Foundation
Schweisfurth Foundation
Shell Foundation
TVE International
World Bank

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Eurosif is proud to collaborate with the Bellagio Forum in presenting the first European Toolkit designed to assist foundations interested in managing their endowments in a socially responsible way. The idea for developing this product came to light after two initiatives in 2005: first, a Bellagio Forum survey showed that many foundations wanted to combine their financial objectives as investors of their endowments with their concerns about social, environmental and ethical (SEE) issues. Second, Eurosif presented its Social Responsible Investment Toolkit targeted towards Pension Funds at a Bellagio Forum Meeting and it became apparent that this document would be a good starting point in developing a new toolkit specific to foundation needs.

Thus, this Toolkit presents the reader with a framework to better understand fiduciary risk, decision-making criteria and potential strategies around Responsible Investment. I am confident the Toolkit will help foundations better understand the means and ways to integrate SEE issues into the long-term management of their endowments, as it has been developed by leading experts in the field of Responsible Investment among foundations.

Finally, thanks to the way it has been designed, this user-friendly Toolkit allows readers to focus on the content areas most important to them. The tools inside are meant to be read and then put to practice in real life situations. I encourage readers to think of this document in that light – it is for you to extract what is most important in helping you to solve key Responsible Investment issues your endowments are facing.

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EXECUTIVE SUMMARY

Over the last decade, we have observed a growing interest and tendency on the part of many actors to take into account extra-financial aspects of financial asset management. The *Project for Responsible Investment Management of Endowments (PRIME)* is an initiative by the Bellagio Forum for Sustainable Development to help ensure that assets endowed to foundations will be invested responsibly in accordance with the foundations' ethical and long-term sustainability objectives.

The *Bellagio Forum/Eurosif PRIME Toolkit for Foundations* aims at helping trustees better understand and integrate Responsible Investment (RI) practices (often called Socially Responsible Investment or SRI) into mandates they give to asset managers entrusted with the management of their endowments. We aim to provide readers with a resource to assist them as these factors become increasingly relevant to good asset management and the expectations of the public and various stakeholders.

Objectives of the Toolkit

The PRIME Toolkit is intended for trustees, officers and directors of foundations. It addresses the following questions:

- Why should my foundation be interested in Responsible Investment at all?
- Should my foundation's board be concerned about how our endowment is invested?
- Which Responsible Investment approaches are most appropriate to our foundation's overall mission and goals?
- Can a Responsible Investment strategy give equivalent returns to other investment approaches?
- What does Responsible Investing mean in terms of fulfilling my fiduciary responsibility?

Readers should:

- Understand how their foundations might benefit from a Responsible Investment strategy
- Be familiar with issues, players, strategies and ongoing initiatives
- Know what actions to take to get started
- Know where to look for further guidance

Highlights and Detailed Outline of the Toolkit

(1) What is Responsible Investment? And what are perceptions of it?

- There is a spectrum of financial tools to assist fund managers and trustees in engaging in more Responsible Investment practices. These tools include grants, programme/mission related investing, loan guarantees, blended value investing, management of the asset corpus, venture philanthropy and public market indices.
- Responsible Investment is an evolving movement, reflected in a growing awareness by the general population, the larger investment community, companies and governments of the impact of social, environmental and ethical (SEE) risks.
- While current investor research and practices challenge this belief, more than 43 % of foundations surveyed in the Bellagio Forum study contended that using sustainable/social criteria in managing an institution's assets reduces returns, compared with 16 % who believed they increased it and 15 % who thought that it made no difference.
- Only 39 % of the foundations surveyed stated they presently coordinate their mission/programmes and asset management practices, whereas 61 % said that there should be links.

(2) Why is Responsible Investment important for foundations?

- Some want to align the ethical guidelines set in their programmes to help guide their investment practices.
- Others feel that Responsible Investment helps them to reduce their reputational risk.
- RI often includes factors such as Corporate Governance and management quality, which allow shareholders to voice their perspective on critical corporate issues while also protecting their interests as shareholders.
- The business case for RI, in part, is that engaging in such practices helps investors and the companies in which they invest to minimise reputational risk, address possible environmental and

social risks and opportunities, and account for governance practices that may affect financial performance over the long run.

- RI may assist trustees in greater fulfilment of their fiduciary responsibilities by engaging them in deeper oversight of how their institution's total assets are managed, and not simply the grantmaking programme.

(3) What is the Fiduciary Issue? The evolving responsibility of trustees

A 'prudent trustee' understands that 'assets managed to satisfy long-term liabilities should be invested to achieve returns over the long-term'. Trustees understand there are a variety of factors that might affect the long-term financial performance of their investments, including: corporate culture; emerging macro-economic trends; environmental growth potential; future license to operate; global climate change; human capital; stakeholder practices; strategic philanthropy; and unqualified environmental liabilities. This section also reviews the Ethical Investment Research Service (EIRIS) guidelines for Responsible Investment.

(4) Where are others doing? Examples from the real world

This section reviews examples of Responsible Investment practices at European and US foundations which may be of interest to other foundations exploring this topic. Such practices include:

- Management of a venture fund
- Screening (positive, negative and mixed screens)
- Investment in employee-owned businesses
- Letters to companies in their portfolio
- Participation in discussions about engagement strategies

(5) What strategies are available?

- Negative screening
- Positive screening
- Best-in-class portfolios
- Engagement
- Proxy voting
- Combining strategies

(6) What are emerging trends in Responsible Investment?

- Collaborative engagement and voting
- Global Compact initiative
- Integrated Asset Management Strategies

(7) What questions should I ask asset managers and consultants about Responsible Investment?

- Collaborating with existing managers
- Criteria for the evaluation of fund managers

(8) How might I integrate Corporate Governance (CG)/social, environmental and ethical (SEE) practices into investment principles?

- Discussion of strategies

(9) Practical Steps: Walk the talk

- Discuss
- Promote
- Decide
- Draft
- Follow-up

PURPOSE

What is the purpose of this Toolkit?

The Bellagio Forum/Eurosif PRIME Toolkit seeks to help foundation trustees better understand and integrate Responsible Investment practices (sometimes called Socially Responsible Investment or SRI) into mandates they give to asset managers entrusted with the management of their endowments. According to a recent study by the European Foundation Centre (EFC), 'Out of the 62,000 foundations in the old EU Member States, 27,000 foundations surveyed across 8 countries reported combined assets of some 174 billion Euros, an average of over 6 million Euros per foundation'.¹ The Foundation Center reported in its *Foundation Growth and Giving Estimates Preview* that US foundations held \$476.7 billion in assets, and gave away \$32.4 billion in 2004.²

Over the last decade, we have observed a growing tendency to take into account extra-financial aspects of asset management. The wish of Eurosif and the Bellagio Forum is to address directly the growing interest in Responsible Investment by creating the PRIME Toolkit. We also aim to provide readers with the resources they will need as these factors become more and more enshrined in national and trans-national legislation.

Questions this Toolkit will answer

Foundation trustees, similar to other institutional investors, often approach the issues of Responsible Investment with a number of questions:

- Why should my foundation be interested in Responsible Investment at all?
- Should my foundation's board be concerned with how our endowment is invested?
- Which Responsible Investment approaches are relevant for my foundation?

- Can a Responsible Investment strategy give equivalent returns to those of other investment approaches?
- What does this approach mean in terms of my fiduciary responsibility?

Is this Toolkit for me?

The PRIME Toolkit is designed to provide an introduction to a number of key issues and investment strategy options for trustees from endowed and grant-making foundations. Our objective is to provide foundation trustees and executives with the basic tools needed to engage in serious and informed discussions with their fund managers, references to additional information, and knowledge about other practices by their peers. The responsible trustee may not be an expert in finance, but should seek to become conversant in financial issues and various emerging investing strategies in order to effectively oversee their institution's asset management strategy. This document does not serve as a technical manual to work through specific types of asset management strategies. It can, however, be used by foundation heads, trustees, non-profit directors and fund managers as an orientation tool.

How do I use this Toolkit?

The PRIME Toolkit combines background information with case studies on best practice examples and useful tools for trustees. It also contains a [Glossary](#) that explains commonly used terms and [References](#) for further reading.

We do not expect our audience to read this document from start to finish. Rather, it has been designed so that specific areas of interest can be read independently of other sections.

What are the expected benefits?

In reading this Toolkit, trustees will:

- Understand more about Responsible Investment and its relevance for foundations.
- Be familiar with issues, actors, strategies and ongoing initiatives.
- Know what steps to take to start involving other

¹ European Foundation Centre (2005). *Foundation Facts & Figures Across the EU – Associating Private Wealth for Public Benefit*. April., p.3. www.efc.be

² The Foundation Center (2005). *Foundation Growth and Giving Estimates*. Foundations Today Series 2005 Edition.

trustees in exploring how their foundation's investment approach could benefit from a Responsible Investment strategy.

- Become aware of the resources available for further information and guidance on Responsible Investing.

Readers are provided with a series of questions to guide their discussions with fund managers and consultants. Examples of initiatives by other endowed foundations can be used in discussions among trustees.

What will I not learn here?

The Toolkit provides readers with a practical overview to Responsible Investment, including key terms, references for follow up and resources to equip foundation executives to evaluate their investment options. It is our hope those who read this document *will* learn how to evaluate their options, but *will not* learn which investment options are certain to meet their needs.

You will not glean:

- Stock tips
- Recommendations/names of specific financial advisors
- Detailed performance reviews of funds (but where you might find this information)
- Negotiation techniques for talking to your trustees (but what information you might want to discuss)

It is beyond the scope of this toolkit to guide foundations through a self-evaluation, and determine which Responsible Investment strategies are best suited to its individual mission. Instead, readers can consult resources listed within the Toolkit.

I. Background

1. What is Responsible Investment?

In 2005, the Bellagio Forum conducted a survey of executives and boards of European foundations to explore the present state of investment strategies and assess which requirements are seen as priority. Findings from this research helped to guide the development of this Toolkit for foundations that wish to use their endowments to effect positive change.

The survey confirmed that many foundations want to align their financial objectives as investors of their endowments with their programme missions and concerns about social, environmental and ethical (SEE) issues. This investment approach, which is called **Responsible Investment (RI)**, is an evolving movement, whose most recent development is based on a growing awareness by the general population, investors, companies and governments of the impact of SEE risks on related factors such as future financial performance of investments, or issues ranging from sustainable development to long-term corporate performance.

'The corpus' refers to the income-generating assets of the foundation. Traditionally, this is 95 % of a foundation's resources, whereas 5 % is used to support payouts that cover the cost of administration as well as the grantmaking activities of the foundation. If the corpus is managed solely to maximise financial performance and grantmaking activities, this means only 5 % of the resources are driving 100 % of the social mission.³

This Toolkit has been designed specifically to address the management of the asset corpus and provide a resource for foundation directors to use to evaluate their options and engage in informed discussions with investment managers. *If the 95 % of the foundation's resources could be used to maximise financial return, social value and environmental impact, the benefits could be exponentially greater than the impact of grants alone.*

When asked, 'What is the management's perception of investment returns and sustainable/social criteria? Do they think it contributes on average to return or reduces it?', more than 43 % said that it reduces it, compared with 16 % who believed it increased it and 15 % who thought that it made no difference. 26 % never discussed the topic. Yet, looking at the performance of **Socially Responsible Investment (SRI)** Funds, there have been periods where SRI Funds have outperformed non-SRI funds.⁴ In 2004, according to Standard and Poor's, the best performing SRI fund was the £583 million F&C Stewardship Growth fund, which returned 21.8 %, compared with the mean UK Equity fund, which returned 12.2 %.⁵ Regarding the application of social/sustainable criteria to investments and links between mission/programmes and asset management, only 39 % of foundations in the Bellagio Forum study said that there is currently a link, but 61 % said that there should be. This indicates a gap between the supply and demand of products and services for endowed foundation trustees and executives. Possible explanations might include gaps in understanding the overall market, perceptions of Responsible Investment or possible market barriers. Explaining the gap is beyond the scope of this Toolkit. However, the Toolkit can be used to close this gap – helping foundation executives to understand Responsible Investment strategies and providing asset managers with case studies of foundation practices.

As Xavier de Bayser of I.DE.A.M explains, performance is a major aspect of an investment decision. But what is the real meaning of performance? The word 'performance' comes from the English 'to perform' which itself comes from the French '*parformer*'. The real meaning of performance is, therefore, achievement. And the achievement of an investment cannot only depend on return and risk. This would be a very limited approach. The investor has to think about a third dimension: the meaning. The originality of Responsible Investment

³ Emerson, J. (2002). Horse Manure and Grantmaking. Foundation News 7 Commentary, May/June.

⁴ SRI World Group found that 32 of 62 SRI funds had returns that beat more than half of their peer non-SRI mutual funds in 2002. Regarding three-year performance results, 30 of 52 SRI funds topped more than half of their peer non-SRI mutual funds.

⁵ Foster, J. (2005). Study shows rich look for social responsibility. *Investment Adviser*, 24th January. p. 11.

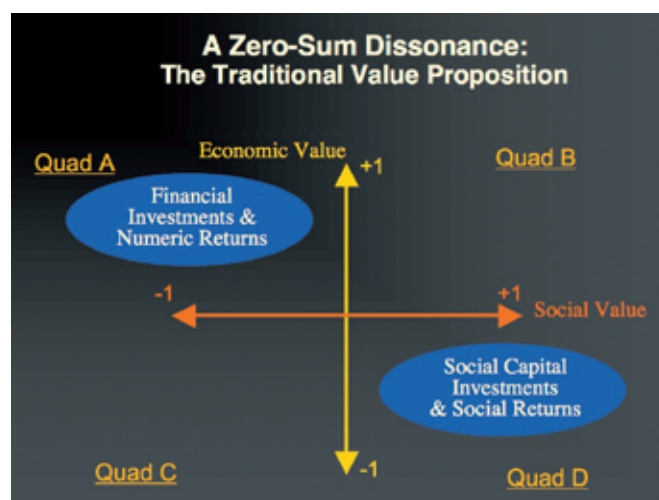
lies in this third dimension. More and more, investors – both institutional and private – consider this third dimension as essential.

The attractiveness of this approach is that if you first look upon this dimension of meaning, you realise that you obtain a better quality of return and a lower risk. For most of these investors, risk should not be considered as a short-term concept but as a long-term one. As a result, volatility as a short-term concept is very often inappropriate to measure a long-term performance. RI's concern with the behaviour of companies in connection with environment and social issues and governance significantly lowers long-term risk. In this respect RI is, therefore, a less risky investment. In conclusion, we can say that Responsible Investment provides the investor with a better performance because, whilst procuring a real achievement it brings a better quality of return and a lower risk.

It could be said there is a spectrum of financial tools for Responsible Investment, which includes a range of options for not only foundation asset managers but any individual interested in engaging in Responsible Investment, from those with a stronger focus on social returns (e.g. grants, programme related investments) to those with a greater focus on financial returns (e.g. public market indices, private equity). 'Blended value' investing falls in the middle of this spectrum. This section of the document reviews these different options for Responsible Investment.

A spectrum of Responsible Investment-looking at return

Work by Jed Emerson, Senior Fellow with the Generation Foundation of Generation Investment Management and Research Fellow at Said Business School at Oxford University, frames the value propositions of social capital investments and financial investments as a 'zero-sum dissonance'. Financial investments expect a high return in economic value, but not social value. Social capital investments are expected to yield high social returns, but not economic returns. This is the zero-sum dissonance, but there are other ways of thinking about return, such as a 'blended value'.



Source: Jed Emerson (2006) (See www.blendedvalue.org)

Grants

Emerson makes a distinction between traditional grants and recoverable grants. Traditional and/or strategic grantmaking might be a charitable gift. Further, traditional and/or strategic grants might be single or multiple year gifts of funds to support programmes, projects, operations, or capacity building. Usually, they have a fixed term and are allocated to support something defined upfront. A recoverable grant is a different type of placement, which often does not have a set term. It allows for recapture at such time as certain benchmarks are attained, and in some ways is akin to generating a 'put' in the stock market. While recoverable grants may not provide a real equity return to the capital provider, they may be structured to pay an interest rate or other return based upon the achievement of certain benchmarks.

Programme Related Investing

A **Programme Related Investment (PRI)** is a recoverable financial investment (not a grant) made with charitable intent to create social impact, where financial risk/return is intended to be concessionary. This might also be called Mission-Related Investing (MRI), the term used more often in Europe. MRI/PRI's account for 1/10th of 1 % of the \$ 500 billion in total US-based foundation assets. PRI's count towards the 5 % minimum payout required by US foundations.⁶ (This is not a requirement in the UK, for example). When/if recaptured, the

⁶ US foundations that make international grants must make certain that the money is being used for charitable purposes and will count towards the minimum 5 % requirement

funds have to go back out in the form of new PRIs or regular grants. They do not invoke fiduciary issues in the same way that the asset corpus does, and are not risk adjusted for financial return on investment.⁷

Loan/Credit Guarantees

If a borrower does not have sufficient collateral, another party may pledge assets or general credit to meet the loan obligation if the borrower defaults. The party pledging the assets is the guarantor, and often must place securities or other assets in an account that can be easily accessed by the lender in the event of a collateral call. This is called a loan guarantee or credit enhancement.

The versatility of the loan guarantee structure is well-known. 'It can only be applied to a project that can be leveraged with debt; that is, the project must have relatively predictable cash flows. A loan guarantee might be used to launch a new project that may be somewhat speculative. The history of microfinance bond offerings and loan guarantees are profoundly intertwined, and loan guarantees were essential to the first issues as well as some of the most recently offered securities.

Loan guarantee arrangements are suitable in a variety of situations. Specifically, they can be useful to spur investment in new financial products, the likes of which mainstream commercial lenders have never seen. Another advantage of loan guarantees is that they can reduce exposure to currency fluctuations and, in the process, shift the exposure from the borrower to the guarantor. Under this arrangement, one only needs to convert one currency to another in the event of a default that results in a capital call!⁸

SRI has had two strategies, one being exit (sell or do not invest in troublesome companies), and the other voice (engage as owners in changing the companies).

Ralph Nader
US consumer activist

Blended Value Investing

The concept behind blended value investing is similar to the adage 'man cannot live by bread alone': there are financial needs, but also social, environmental, and ethical needs. As Professor Emerson puts it, 'Traditionally, we have thought of value as being either economic (and created by for-profit companies) or social (and created by nonprofit or non-governmental organizations). What the "blended value" proposition states is that all organizations, whether for-profit or not, create value that consists of economic, social and environmental value components – and that investors (whether market-rate, charitable or some mix of the two) simultaneously generate all three forms of value through providing capital to organizations'.⁹ The concept of 'blended value' has many implications for individuals, foundations and capital managers. In the context of this study, 'blended value' investing encompasses all classes of investments pursuing such multiple goals, including Socially Responsible Investments and Private Investment for Social Goals.¹⁰

Private Equity / Social Venture Capital

Private Equity and Venture Capital are synonymous with the technology boom during the 1990s, which began with investments made in the 1980s. The word 'venture' suggests some degree of risk, or even a gamble. 'The venture capital industry supplies capital and other resources to entrepreneurs in business with high growth potential in hopes of achieving a high rate of return on invested funds'.¹¹ Some of these same venture capitalists, and also entrepreneurs in whom they invested, decided to bring this philosophy to the social sector: adapting strategic investment management practices to generate high social rates of return.¹²

The European Venture Philanthropy Association (EVPA) defines *Venture Philanthropy* as 'a field of philanthropic activity where private equity/venture capital models

7 World Economic Forum (2006). Blended Value Investing: Capital Opportunities for Social and Environmental Impact. pp.36-38. (See www.blendedvalue.org)

8 World Economic Forum. (2006). Blended Value Investing: Capital Opportunities for Social and Environmental Impact. pp.36-38. (See www.blendedvalue.org)

9 See: www.blendedvalue.org

10 See: "The Blended Value Map" by Jed Emerson, et.al. at www.Blendedvalue.org for additional papers and materials on CSR, SRI, Social Enterprise and Sustainable Development – and how each of these arenas fits within a broader, value maximizing worldview.

11 "Note on the Venture Capital Industry (1981)," HBS Case 285-096, Harvard Business School, 1982, p.1.

12 Venture Philanthropy: Leveraging Compassion with Capacity, Address by Mario Morino, March 8, 2001. To review original writings and research on venture philanthropy strategy, please see www.redf.org.

are applied in the non-profit and charitable sectors'. There are many different forms of venture philanthropy but the EVPA believes it can be characterised as:

- The active partnership, or engagement, of donors, volunteers, and/or experts with charities to achieve agreed outcomes such as organisational effectiveness, capacity building or other important change;
- The use of a variety of financing techniques in addition to grants, such as multi-year financing, loans or other financial instruments most appropriate for a charity's needs;
- The capability to provide skills and/or hands-on resources with the objective of adding value to the development of a charity; and
- The desire to enable donors to maximise the social return on their investment whether that be as a financial donor or as a volunteer of time and expertise.¹³

What differentiates a 'social entrepreneur' from an 'entrepreneur' is debatable. Investments in areas such as clean technology, renewable energy and bio-fuels have attracted interest from traditional venture capitalists, given the projected growth of these markets. As Responsible Investment becomes more mainstream, and traditional investors take a more 'blended value' approach, this debate will continue to evolve.

Public market indices¹⁴

Indices are based on creating a group of publicly traded stocks from a specific area, or from a specific industry. An example is the Standard & Poor's 500 Index (S&P 500), which includes 500 companies that account for about 71 % of the total capitalization of the market.¹⁵

SRI Indices and mutual funds are based on a group of publicly traded stocks which use social screens to put together the index. In both the US and in Europe, there are now a number of indices available that track socially responsible companies, such as the *FTSE4Good*, *Dow Jones Sustainability Index*, *Calvert Social Index*, and *Domini 400 Social Index*.

¹³ See: www.evpa.eu.com

¹⁴ A suggested reference book is called 'The SRI Advantage: Why socially responsible investing has outperformed financially' by Peter Camejo.

¹⁵ Camejo, P. (2002). *The SRI Advantage: Why socially responsible investing has outperformed financially*. San Francisco: New Society Publishers, p.11.

Bonds

As R. Andreas Kraemer of Ecologic explains, many endowments will invest not only in company stocks but also in bonds or bond funds, either exclusively or in a balanced mix with other investments. Bonds are comparatively safe investments, making them attractive to risk-conscious trustees as well as regulators seeking to protect the asset base of endowed foundations. It is therefore worth considering how to apply ethical, environmental and social standards to the issuers of bonds and similar instruments, and to look at the relationship between financial performance of bonds and ratings on the basis of non-financial criteria.

Most endowments focus on government and corporate bonds with high ratings, and invest in the safer end of the risk spectrum available on the bond market:

- Public sector bonds, ranging from government to municipal bonds, those issued by public companies or international governmental organisations. All these bonds benefit from explicit – or implicit but credible – guarantees by sovereign governments;
- Private sector bonds, mostly corporate bonds of (listed) companies, including bonds representing receivables such as mortgages or students loans as well as other specialised instruments, such as bonds for infrastructure investment or financing railway rolling stock.

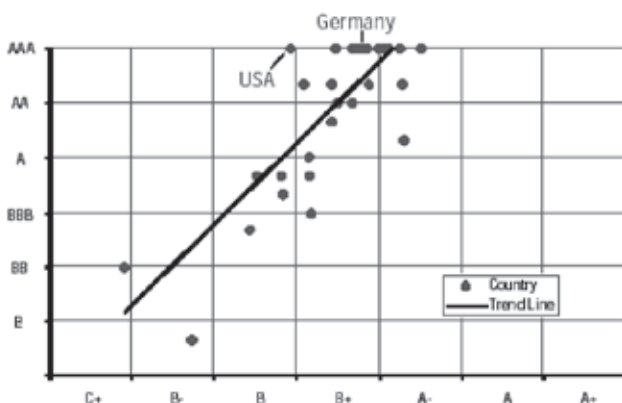
In some cases, the distinction between public and private sector bonds is blurred and both classes – as well as hybrids – offer risk profiles ranging from safe to 'junk'.

When assessing listed companies and similar issues of (corporate) bonds, essentially the same criteria and indicators, methods and investment strategies apply, as is the case with Responsible Investment in company stock.

However, bonds offer one additional variable in that some, but not all, are issued for specific purposes. One issuer, for instance a commercial bank, may issue bonds representing very different financial functions. One bond may be issued to finance the building of a nuclear power plant, for instance, and another may represent mortgages on energy-efficient homes. Many

responsible investors considering social and environmental implications will want to distinguish between bonds with such different backgrounds.

Oekom Research, a leading sustainability rating agency based in Munich, Germany, in September 2003 examined the link between a country's financial credit standing and its sustainability performance.¹⁶ In a regression analysis, the results of *Oekom Research's Country Rating* were compared with *Standard & Poor's Sovereign Credit Rating* and two competitiveness indicators, the World Economic Forum's Growth Competitiveness Index and Microeconomic Competitiveness Index.



Comparison of Oekom Research Country Rating with S&P Sovereign Credit Rating

A note about timeframe and expectations

In the Toolkit, we frequently refer to investment timeframes: short-term, medium-term and long-term. The standard definitions and underlying assumptions are worth addressing. Short-term investments expect a return in less than one year, medium-term between one and ten years and long-term more than ten years. Measuring financial return on investment is a straightforward procedure. Methodologies to calculate the social return on investment are still evolving, which also bear consideration of investor expectations within a given timeframe. Taking a 'blended value' approach requires thinking through both return expectations and the timeframe within which one expects to see the generation of financial, social, and environmental returns.¹⁷

¹⁶ See: www.oekom-research.de/ag/Performance_Countries.pdf

¹⁷ For additional information on SROI practices, please see the SROI Primer (<http://sroi.london.edu/>) and SROI documents at www.redf.org.

KEY TERMS

Asset Corpus
Blended Value Investing
Loan Guarantee
Programme Related Investment
Responsible Investment
Socially Responsible Investment
Venture Philanthropy

FTSE4Good
Dow Jones Sustainability Index
Domini 400 Social Index

2. Why is Responsible Investment important for foundations?

Foundations exist for a purpose. Whether they focus on social, cultural, environmental or other issues, nearly universally their mission is, in some respect, 'to make the world a better place'. As a result, from a financial point of view, they are organisations that allocate capital to areas where neither government nor private investors are willing or able to do so. In this respect they are risk takers; and big risks often come with large potential rewards. Paul Ylvisaker, a legendary officer at the Ford Foundation, described foundations as a society's 'passing gear'. In most countries the value of their contribution is rewarded with a special tax status, because of this special contract with society. So what do they have to do in return? First of all, foundations have to strive towards achieving that special social purpose. We believe they also have a special obligation: to invest in a manner consistent with their institutional mission.

The primary reasons why foundations may decide to invest 'responsibly' may vary. Some foundations may want to follow the same strict ethical guidelines they set in their programmes also for their investment mandates. This is often described as a **values-based investment approach**. Other foundations may set the primary focus on financial return, but believe that Responsible Investment elements may reduce the risk el-

ements and even enhance returns. They follow what in traditional terminology is called a **shareholder value-based strategy**.

In most cases, investors find their motivation is a mix of both, and there are a number of means employed to act on information related to SEE risks.

Today's trustees may also think of Responsible Investment as incorporating **Corporate Governance (CG)**. Indeed, as mainstream institutional investors' interest in Responsible Investment has been increasing,¹⁸ and so too have questions about how it relates to Corporate Governance. For this reason, it is necessary to explain the links between Responsible Investment and Corporate Governance.

Why is Corporate Governance (CG) an important element of Responsible Investment, especially for foundations?

Reputational risk is a key concern for foundations. As shareholders they become stakeholders in the companies their endowments are invested in. Corporate Governance is intrinsically the vehicle of respect for their rights and interests. Advocates of good Corporate Governance wish to see greater accountability from the side of corporate management in order to ensure the long-term well being of the company and of its stakeholders; and avoidance of any corporate behaviour that may negatively influence the reputation of the firm and thus its shareholders.

How does good CG enable Responsible Investment policy?

Corporate Governance allows active shareholders to voice concerns that deal with non-financial aspects of corporate life through engagement and voting strategies. Some foundations have used that right actively to align their investments with the objectives of their foundations. Examples include:

- Disclosure requirements that enable shareholders to ask for information and thus help ground a dialogue with companies on facts rather than assumptions;
- The right to file shareholders' resolutions at annual general meetings (AGMs) in the case of continuing

disagreements between shareholders and management, thus allowing shareholders to give an ultimate warning before a vote is cast. Presently, this issue is one of the weak points of European legislation, as usually only large shareholders are entitled to file resolutions; and

- The defining of shareholder rights on voting.

Currently, shareholders are not always granted voting rights commensurate with their share holdings. Many advocates would like to see a rule of 'one share – one vote – one dividend' enforced.

Why should foundations do it?

Trustees will first and foremost want to know whether Responsible Investment may add value to their financial plans and strategy, that is, whether it is compatible with their fiduciary duty. *In other words, how may the consideration of non-financial returns be in line with the asset manager's goals for the beneficiary?*

Eurosif and the Bellagio Forum contend that if the reader accepts the business case – outlined below – for responsible investment, then the fiduciary case will follow. Further, although in the short-term the business case for Responsible Investment may not always be evident, when looking at Responsible Investment from the perspective of a long-term investor – and foundations are normally regarded as long-term investors – the arguments for incorporating Responsible Investment become more apparent.

We will start with the business case first.

As forces of globalisation continue to gain momentum, society increasingly demands that large multinational corporations improve their performance in areas of human rights, the environment, worker health and safety and other governance issues. Failure to address these demands has proved damaging to a company's most important asset – its reputation"

- Glen Peters, PwC

¹⁸ The Eurosif 2003 study on Institutional Investors and SRI sized the market at up to €336 billion.

FROM THE BUSINESS CASE...

At present, Eurosif and the Bellagio Forum see the evidence on Responsible Investment fund performance as largely positive or neutral. Here's why:

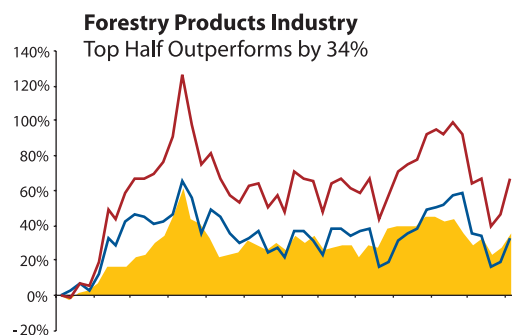
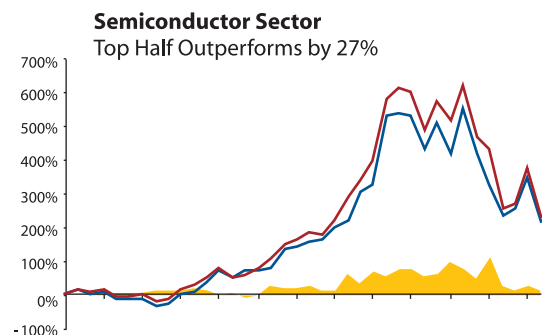
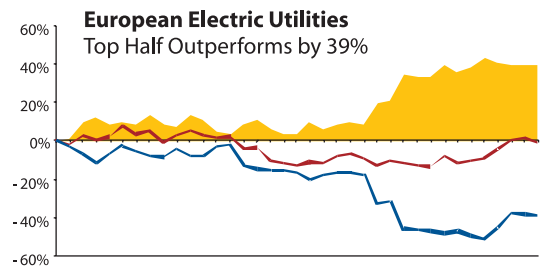
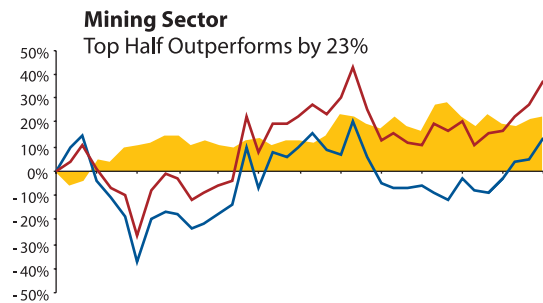
On company performance:

The definition of *Corporate Social Responsibility*¹⁹ (CSR) remains a point of contention. Noted economist Milton Friedman argued as early as 1962 that companies should be left to maximise their profits and stock performance and leave it to shareholders to determine whether their money was being earned in acceptable ways.²⁰ Responsible Investment is inherently a long-term approach to investing, sometimes at odds with the short-term vision prevalent on financial markets. It is possible to argue that CSR policies will impact company value in the long run through improvement of reputation, reduced risk, better use of resources and new market opportunities.

When focusing within sectors, we can observe that the share price performance of companies that rank in the top 50% on environmental performance is substantially better than those rated in the bottom half.²¹ This difference was most pronounced in the sectors most exposed to environmental issues, such as the mining and forestry.

Sector Analysis including measurement of intangibles

■ Difference ■ Above Average EV21 Rating ■ Below Average EV21 Rating



28th October 2004
Katie Gordon

Source: Innovest

FINANCIAL DYNAMICS
BUSINESS COMMUNICATIONS

¹⁹ CSR addresses corporate practice, as opposed to SRI, which addresses financial investment practice.

²⁰ Within the limits of law and ethical custom, Friedman added. He thought law should define the social responsibilities of corporations.

²¹ Katie Gordon, Cazenove Presentation at CSR Conference Frankfurt Oct 2004

On Responsible Investment screened fund performance:

The Bellagio survey shows that many trustees still believe that Responsible Investment performs less well than conventional funds. With 20 years of performance, these concerns might be decreasing. As EIRIS points out, 'Responsible Investment may bring an information advantage through its focus on materially important issues that are often overlooked. Considering issues such as brand values and Corporate Governance helps to show investors how a company behaves and may allow them to spot opportunities and avoid investments which could run into serious trouble.'²²

Unfortunately we have insufficient data about the performance of sustainable investments over a range of years (only since 1996). Nevertheless, one comprehensive study, Margolis and Walsh (2001) synthesised 80 studies on SRI portfolios, producing some interesting findings on SRI. More than 50% of the studies indicated a positive link between CSR practice by companies and SRI fund performance. Only 5% of these studies showed a negative link. The remainder, however, failed to evidence the link between relative performance and the funds' SRI approach. Thus, the conclusions testify largely to a neutral or positive link.

In an article entitled, "Answers to Four Questions,"²³ Lloyd Kurtz cites studies in three categories: environment, corporate governance, and employee relations. He reports that many recent studies have claimed positive effects from social factors on both financial performance and stock price. The four questions around which Kurtz structures his article can be used to guide our evaluation:

- What do financial theories have to say about SRI?
- What has performance been and what are the risks?
- Could there be an investment benefit to SRI?
- What do we know about social investors and their behaviour?

Positive case examples: Recent studies indicate that when a certain aspect of CG/SEE issues becomes

quantifiable, taking into account those aspects in investment decision-making brings positive results. Four cases below, on **reputational risk**, **eco-efficiency**, **social issues** and **corporate governance** are provided as examples:

1) Reputational risk

One way to get a sense of reputational risk is to look at eBay. Members of eBay, who may be buyers or sellers, use a customer feedback system to publicly rate each member's reputation. One study found that a seller's good reputation added 7.6% to price received.²⁴

Companies and investors increasingly acknowledge reputational risk as part of the measurement of its value and in fact, it has been reflected in share prices and P/E ratios that are far too long above their historical averages. Some of the key aspects are:

- Government's decisions to grant operating licenses;
- Consumer decisions to buy products;
- Job-seekers' decisions to apply at a company; and
- Impact of a CG/SEE event on share price.

As an illustration, the last aspect is demonstrated in a 1997 study by the University of Pittsburgh of stock market reaction to 27 incidents of socially irresponsible and illegal behaviour, involving lawsuits, fines and product recalls. This study found that such companies suffered very significant losses in shareholder wealth, which were not subsequently recovered.²⁵

In the UK, the revised Charities' SORP (Statement of Recommended Practice for Accounting) Regulations 2000, requires foundations to consider risk. It states that the trustees' report must include 'a statement confirming the major risks to which the charity is exposed, as identified by trustees, have been reviewed and systems have been established to mitigate those risks.'²⁶

2) Environment and eco-efficiency

Corporate environmental issues are frequent objects of social and regulatory pressure. They are also associated with management skill. A recent study by Derwall,

²² EIRIS (2005). Investing Responsibly: A practical introduction for charity trustees. See: www.eiris.org/Pages/TopMenu/Public.htm

²³ Kurtz, L. (2005). Answers to Four Questions. *The Journal of Investing*, 14:3, p. 125-139.

²⁴ Resnick, P., Zeckhauser, R. J., Swanson, J. & Lockwood, K. (2002). The Value of Reputation on eBay: A Controlled Experiment. KSG Working Paper Series No. RWP03-007. July. Available at SSRN: <http://ssrn.com/abstract=385206>

²⁵ Eurosif (2001). Just Pensions Guide for Trustees, May 2001.

²⁶ EIRIS (2001). "Making Charitable Investments Work", Ethical Investor.

Günster, Bauer and Koedijk (2004)²⁷ tackles the impact of eco-efficiency on stock performance.²⁸ By using eco-efficiency scores established by a rating agency, the authors created two equity portfolios. The study demonstrated that the portfolio containing companies with high eco-efficiency scores provided substantially higher average returns than its low-ranking counterpart over the period of 1995-2003, even after transaction costs. The results of this study have been publicly endorsed by mainstream asset managers such as the CIO of Global State Street Advisors.²⁹

3) Social issues

Some social issues, such as child obesity, have had extensive coverage in the press and impacted share price. Companies such as Britvic and Northern Foods, in the UK, Coca-Cola in the US and others have seen their share prices drop as they have not demonstrated to consumers a healthier range of products. Child labour and other employment issues are also very important to the business case due to the potential impact on company reputation and share price. The Burma Campaign in the UK, for example, maintains 'The Dirty List' of companies, throughout the world, which support the regime in Burma.³⁰ Nestle's business suffered following its marketing of baby milk formula in developing countries. Boycotts have been launched against companies, such as Unilever, which test some of their products on animals. Lists naming and shaming these companies can easily be found on the internet.³¹

4) Corporate governance

Stock market research supports the claim that good Corporate Governance impacts the share price. In a recent study, Professor Metrick, Paul Gompers and Joy Ishii of Harvard University graded the level of shareholder rights of 1,500 US companies on a scale of 1 to 24. The higher the score, the less say shareholders had. Companies with the strongest shareholder rights had a governance score less than 5 and were part of the

'democracy portfolio', while those with the weakest rights – those with a score greater than 14 – were part of the 'dictatorship portfolio'. The democratic firms significantly outperformed their autocratic peers. According to the study, an investment of \$ 1 in the democracy portfolio on September 1, 1990, would have grown to \$ 7.07 by December 31, 1999, or 23.3 % annually. Companies in the dictatorship portfolio, in contrast, would have only been worth \$ 3.39 in December 1999, a growth of 14 % annually.³²

... ON TO THE FIDUCIARY CASE

If we believe Responsible Investing is a strategy worth exploring, there still may be questions regarding whether such practices fall within a trustee's fiduciary responsibility. Let's take a look at how doing so affects the most important factor: the bottom line.

The business case suggests that the link between Responsible Investment and fund performance is positive or neutral. Thus, a fiduciary case for Responsible Investment becomes easier to justify. Simply put, the fiduciary duty of an institutional investor is to carry out investment decisions in the primary or sole interest of its beneficiaries – though an exact definition and/or interpretation may vary slightly. It is left up to the interpretation of practitioners, academics and local culture. It could be said that there is a larger consensus around the fiduciary case for good Corporate Governance, while other SEE issues are still perceived with uncertainty by many parts of the investment community. Indeed, there are different and opposing views on how fiduciary duty allows CG/SEE criteria to be integrated into the investment process.

In Britain, a nation with one of the world's leading financial centres, as well as a long tradition of endowed foundations, the debate on CG/SEE criteria has been going on for the last decade. Engagement strategies are preferred among UK pension funds, but for foundations there is more leeway to explore other strategies, such as screening. These are discussed in more detail in Section 4.

The key debate in Europe is around how screening reduces the potential for diversification and how it could

27 See www.epn-magazine.com.

28 The Eco-Efficiency Premium Puzzle, Derwall, Günster, Bauer & Koedijk, May 2004.

29 Eurosif would like to acknowledge the participation of Rob Bauer in conceiving this business case.

30 See www.burmacampaign.org.uk/dirty_list/dirty_list.html

31 Examples of such lists include: Ethical consumer (www.ethicalconsumer.org/boycotts/boycotts_list.htm); Multinational monitor (www.multinationalmonitor.org/); and Corp Watch (www.corpwatch.org/)

32 Quoted from www.nyse.com

thus be incompatible with fiduciary duty. Screening advocates reply that reducing the investment universe is quite common under some circumstances (for example, when funds only invest in companies of a certain size: small caps, mid-caps and large caps).

The leading continental European view is that using the best-in-class approach is actually good for long-term investors such as foundations and pension funds because it allows investors to eliminate risk factors and accumulate profit potential through a more thorough portfolio analysis that integrates CG/SEE risks and opportunities.

Another common view in Britain, as advocated by the Trade Union Congress (TUC) and leading asset managers, is that voting rights are part of the asset of owning a share, and that the exercise of these rights is a fiduciary duty.

These views, however, are likely to evolve as legislation, experience, and research in these markets increase and become more specific over time, and practices spread to new countries.

Understanding the legal framework

A legal framework for the integration of SEE and governance issues into institutional investment is summarised in a concise report produced by Freshfields Bruckhaus Deringer for the Asset Management Working Group of the UNEP Finance Initiative.³³

The objective in preparing this report was to answer the following question put to us by the Asset Management Working Group (AMWG) of the United Nations Environment Programme Finance Initiative (UNEP FI):

We have also been asked to identify any common misconceptions against such integration. In raising this question, the AMWG has indicated that it wishes to understand whether the commonly held view that fiduciary duties require a portfolio manager solely to pursue profit maximisation is a correct interpretation of the law or whether act-

ing in the interests of beneficiaries can also incorporate other objectives. Those objectives might include the creation of institutional and societal conditions that favour, in the long term, the interests of beneficiaries, such as protecting the environment. The AMWG has also pointed out that different investment time horizons may dictate different investment analyses and strategies, in that long-term risks, such as risks associated with environmental damage, will be more relevant for long-term investors, and have asked to what extent the law recognises this.³⁴

The jurisdictions examined included France, Germany, Italy, Japan, Spain, the UK and the US. The position in Australia and Canada were also examined, due to the level of academic interest. The study concluded, that 'integrating ESG considerations into an investment analysis so as to more reliably predict financial performance is clearly permissible and is arguably required in all jurisdictions'.³⁵ The study also contains a flow chart to show the process involved in taking ESG considerations into account.

In conclusion of this section, we bring to your attention:

- There is a fiduciary case for the long-term investor;
- How that fiduciary case is translated into practice depends on your country's and organisation's acceptance of screening and/or engagement and voting strategies; and
- That regardless of these current acceptance levels (as we will show later), each strategy may be best adapted to address a specific type of issue.

KEY TERMS

Corporate Governance
Eco-efficiency
Reputational Risk
Value-based investment approach

³³ Report can be downloaded from the Bellagio Forum website: <http://bfsd.server.enovum.com/en/content/view/138/>

³⁴ Freshfields Bruckhaus Deringer, (2005). A legal framework for the integration of environmental, social and governance issues into institutional investment. UNEP Finance Initiative, p.6-7.

³⁵ Ibid., p.13.

3. What is the Fiduciary Issue? The evolving responsibility of trustees

If you are a foundation trustee, or someone who deals with trustees, your responsibility to execute programming and to manage your financial assets go hand in hand. Although an investment manager may provide expertise and advice to meet your financial objectives, it is the board's responsibility to secure the reputation of the foundation. When the investments are destroying the very value you seek to create, your reputation is at risk: a foundation dedicated to cancer prevention that invests in tobacco companies will likely risk its reputation in the eyes of the public.

The first half of this section provides an overview of the fiduciary responsibility of a trustee and includes an extensive reference to a joint publication by the Generation Foundation (US/UK) and Rose Foundation (US). Although the examples included in the text are North American, the lessons are relevant to Europe, which, of course, also has its own set of actors, history and context.

The Prudent Trustee: The evolution of the long-term Investor

'The responsible trustee (especially trustees charges with maintaining long-term funds, such as pensions and endowments) must understand that

The investment objectives set by trustees should compliment the investment horizon of funds under management- namely, assets managed to satisfy long-term liabilities should be invested to achieve returns over the long-term.

And that

The definition of prudence and trustee responsibility that governs our understanding of fiduciary responsibility has evolved over time. As more evidence unfolds supporting the connection between sustainability and financial performance, those who do not consider these factors in investment decisions could ultimately leave themselves open to charges of imprudence.³⁶

The responsible fiduciary is one who seeks to assess long-term economic, social, and environmental factors that are already major (if poorly understood) value drivers today. The responsible fiduciary is also one who seeks to understand how these factors may represent both risk and reward to their portfolio of investments— and one who then seeks out fund managers capable of allocating assets with an eye to protecting against such risks while positioning investments to capture potential rewards.³⁷

As growing numbers of fiduciaries consider their evolving role, one obvious question that arises has to do with whether trustees have the legal right to consider long-term factors that may be 'extra financial' or involve qualitative elements (since many long-term issues cannot be boiled down to short-term quantitative and financial analysis).

³⁶ Emerson, J., Little, T., and Kron, J. (2005). *The Prudent Trustee The Evolution of the Long-Term Investor*. Washington, DC: The Generation Foundation and the Rose Foundation, p. 2. (See www.rosefdn.org/prudenttrustee.pdf)

³⁷ *Ibid.*, p. 8

While the legal aspect of fiduciary responsibility requires thorough review and thought, for now let us make the following points:

First, whenever a trustee makes an investment decision with respect to the funds under his/her responsibility, it is done in the context of legally binding 'fiduciary duties'.³⁸

Second, it is permissible for fiduciaries to consider extra-financial, collateral benefits.³⁹

Third, and finally, traditional approaches to tracking the performance of companies and assessing their long-term liabilities (and thus potential for generating competitive shareholder returns) do not adequately consider the full cost of many firms' business practices.

There are various ways in which fiduciaries may act to engage companies in which they have investments to explore issues of unstated costs, governance and related topics of concern to fiduciaries. For example, a pension fund or foundation could review its holdings, selecting a subset of companies with poor environmental records relative to their industry peers. Similar to many funds' long-standing practice of active engagement on Corporate Governance issues, the fund could then approach the poor performers to discuss the companies' plans for environmental improvement. Exerting such pressure would be based on the reasonable assumption that it would be likely to improve the value of the companies and consequently the value of the pension fund's assets. A number of funds, such as the British-based USS, CalPers, and the members of The Marathon Club (consisting of pension fund managers who meet to explore what it means to be a long-term and responsible investor) already conduct similar programs related to improving Corporate Governance. Including environmental considerations in this type of program could be a very cost-effective way of ensuring that the duty to monitor has been fully respected.⁴⁰

There are a variety of factors investors might consider that will affect the long-term financial performance of their investments. For example, the strategic investor will want to consider the following possible points, presented alphabetically:

Corporate culture

In the long run, the culture of a firm may greatly affect both the return risk and growth opportunity. Over recent years, there have been many examples where unethical or 'corner-cutting' firm culture created situations where shareholders ended up losing many millions of dollars. Enron is an oft-used example, but Citibank is a more contemporary one – despite its recent laudable efforts to change its culture. Specifically, Citibank has been beset by consistent and considerable fines totalling hundreds of millions of dollars per year, while also losing revenue opportunities due to unethical behaviour by being banned from the asset-management business in Japan, and from controversy surrounding its Eurobond dealing. A lax culture of ethics at Citibank resulted in concrete material losses and lost future opportunities for the business, and therefore for shareholders. However, culture may also lay the foundation for significant long-term value creation. In the case of T. Rowe Price, it has been able to create real value by managing for client trust and long-term value – returns that resulted from the creation of a culture of total integrity – and its investors were rewarded by the firm's being able to avoid recent mutual-fund scandals.

Emerging macro-economic trends

Overarching trends such as global warming in the context of, for example, the energy and automotive sectors, or the introduction of genetically modified organisms (GMOs) and their impact on food production and agricultural firms will inevitably affect the ability of corporations to function profitably over the long run.

³⁸ *Ibid.*, p. 8

³⁹ *Ibid.*, p. 9

⁴⁰ *Ibid.*, p. 10

Environmental growth potential

The risk here is failure to capture the environmental alpha in various emerging markets such as those that provide opportunities for either new product development or investments in equity or fixed-rate financing of renewable and emerging clean technology. An example of one company moving to capture this opportunity is GE.

Future license to operate

While current production or manufacturing practices may presently be legal, or even customary, these same practices may affect the firm's future license to operate (such as gas extraction or mining practices that destroy surface property). The pharmaceutical industry faces this issue as well in the context of governmental reaction to treatable but still raging diseases like malaria, emerging threats to macroeconomic stability like diabetes and hard to identify and treat global pandemics like HIV/AIDS. Regulatory factors also play out with regard to whether, how and under what conditions companies are allowed to operate. For example, the Standing Committee on Foreign Affairs and International Trade of the Canadian Parliament recently proposed regulation of Canadian companies involved in overseas mining to adhere to significant human rights and environmental regulations that would be overseen by the Canadian government – not the countries within which such practices might take place.⁴¹

Global climate change

The focus of many investor discussions and working groups, climate change represents a serious and real threat to any portfolio of investments. The recently published report, *A Climate For Change: A Trustees Guide*, is an excellent presentation of both the issue and challenges for trustees.⁴²

Human capital

A firm's human capital is on the one hand critical to corporate success and on the other an often mismanaged long-term asset. There are three aspects to human capital worth considering: Internal, Customer, and External.

An example of customer-oriented human capital management was documented in a recent study exploring the benefits of improved management and services upon real estate investments. The report found that, high quality building services improve tenant satisfaction, turnover and mix. These in turn increase rent levels, occupancy rates, lease renewals and market image, thereby enhancing the market value of a property and its rate of return. As prominent real estate industry analysts put it, 'Landlords in the real estate industry with the best services, like landlords in the lodging industry with the best service, will command above-average rents and occupancies over time.'⁴³

Finally, an example of how External Human Capital Management is assessed is found in the question of reputation risk management. What is clear is that increasingly the value of a company is not represented by tangible assets, but rather the intangible assets of the firm. Current accounting practices do not adequately track reputation, brand and cultural value within companies – yet it is those very factors which drive a significant part of the firm's competitive position within markets – whether financial markets or consumer markets. The fact is, while they play important roles, one does not manage companies with attorneys and accountants – one needs leadership that can nurture a solid reputation which often comes from being inspirational and responsive to employees. The truth is that markets are increasingly rewarding firms that do not force employees to 'hang up their values at the door' – and the market is rewarding those companies that realize this reality.

41 Please see: www.parl.gc.ca/committee/CommitteePublication.aspx?Sourceid=122765

42 Please see www.thecarbontrust.co.uk/trustees for copies of this report.

43 See: Jonathan Litt and Gary Boston from Salomon Smith Barney quoted in Pension Real Estate Association Quarterly, Spring 2000. For the full report, please see: www.seiu.org/docUploads/impact_of_Quality_Building_Service.pdf

Stakeholder practices

Firms that choose to ignore the interests of various stakeholder groups do so at their own risk. Monsanto didn't pay attention to European stakeholders when introducing Genetically Modified Organisms (GMO's) to crops marketed in Europe and paid a real price in lost market share and revenues. On the other hand, firms such as Novo Nordisk (with its highly ethical and stakeholder-led design of animal testing facilities) and BP have learned how to work with and integrate the concerns of stakeholder groups to the benefit of stakeholder and shareholder alike.

Strategic philanthropy

Proactive alignment by a company between its overall interests and a philanthropic strategy is another area of both risk and opportunity. Companies such as Cisco (through its Network Academies) have learned how to create foundation strategies that complement both community needs for high-tech training and company interests in supporting the creation of a highly technically skilled and more valuable work force.

Unquantified or undisclosed environmental liabilities

Many firms face very real, but not well measured or acknowledged, historical liabilities such as mercury, asbestos, and abandoned facilities with toxic contamination. These liabilities exist across industries from heavy manufacturing to automobiles to computer hardware and the long-term costs of these liabilities are increasingly difficult for corporations to ignore.

The practice of taking into consideration investment factors that go beyond traditional financial analysis is evolving. Yet, at present, the type and degree of sustainability practices used by corporate managers may serve as a measure of sound management and value-creation activities that, over coming years, hold the potential to separate good from great investment opportunities.'

What can foundations do to address their responsibilities? According to EIRIS in the UK, foundations should take the following steps to invest responsibly.⁴⁴

Review the charity's current position and resources. Factors to be reviewed include:

- The current investment assets and where they are invested
- Whether the charity's governing document includes any restrictions
- The expertise available and what competencies current fund managers can offer
- What other charities (especially peers) are doing

Setting aims is about moving from a point of interest in Responsible Investment to clarifying why the charity should invest responsibly and what it should seek to achieve from doing so. It may be at this stage that the trustees decide it is inappropriate for the charity to implement Responsible Investment.

Trustees should articulate the motivations for adopting Responsible Investment and consider how it links to the charity's objects, strategy, investment approach and risk assessment. By articulating the above, aims can be set and how value can be added defined. Trustees may wish to consult with the charity's stakeholders.

Initial research on the content of the policy can help trustees clarify which issues to focus on and the implications of different approaches. For example, research can show how many of the companies that the charity currently invests in would be avoided and how setting levels of materiality or specific criteria changes this. To illustrate, if a charity for religious reasons considers avoiding investments in the armaments industry it will want to balance beliefs with continued good financial returns (not avoiding too many companies). The charity may therefore decide to only avoid companies whose main business is armaments. This could be achieved by setting a materiality level on turnover or by distinguishing between companies by the nature of their products. Alternatively, if the charity is considering a support approach, relevant investment opportunities will need to be identified.

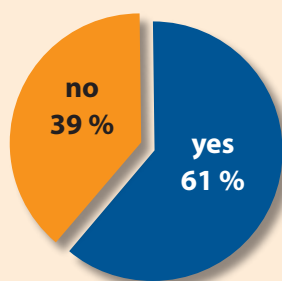
⁴⁴ EIRIS (2005). Investing Responsibly: A practical introduction for charity trustees. See: www.eiris.org/Pages/TopMenu/Public.htm

4. What are others doing? Examples from the real world

This chapter draws upon data from the Bellagio Forum survey of foundation practices, conducted interviews with European foundation executives, information from our partners and an extensive literature review. We include a sampling of case studies from all over the world, including North America and a variety of countries in Europe. We recommend looking at the organisations' individual websites for more detailed information, which are listed in the [References](#) section of the PRIME Toolkit, along with key reports that informed this work.

When asked, "What is the management's perception of investment returns and sustainable/social criteria? Do they think it contributes on average to return or reduces it?", more than 43 % of foundations interviewed said that it reduces it, compared with 16 % that believed it increased it and 15 % who thought that it made no difference. 26 % never discussed the topic. Yet, looking at the performance of SRI Funds, there have been periods where SRI Funds have outperformed non-SRI funds.⁴⁵ Regarding the application of social/sustainable criteria to investments and links between mission/programmes and asset management, only 39 % of foundations in the study said that there is currently a link, but 61 % said that there should be.

Should there be a link between mission and asset management ?



⁴⁵ SRI World Group found that 32 of 62 SRI funds had returns that beat more than half of their peer non-SRI mutual funds in 2002. Regarding three-year performance results, 30 of 52 SRI funds topped more than half of their peer non-SRI mutual funds.

Abell Foundation (US)

The Abell Foundation manages a venture fund, investing in firms that make a commitment to locating or expanding within their local area and also makes grants to non-profits working in those same communities.⁴⁶

Calvert Group (US)

Calvert Group offers investors a variety of socially responsible portfolios of public equities, bonds and money market products. Through investments in companies that meet Calvert's environmental, social and governance criteria, Calvert actively seeks to create social value with its investments and encourages companies to improve through shareholder advocacy. Additionally, Calvert commits a small portion of the assets of a number of its funds to community development financing through the Calvert Foundation (See Appendix).⁴⁷

Cazenove Capital Management Services (UK)

Cazenove Capital Management Services (CCM) provides specialist asset management services to private clients, charities, and institutional clients, including private equity investors. CCM integrates social, environmental and ethical (SEE) ratings into its stock selection matrix and conducts its own SEE research and engagement. Analysts raise SEE issues at company meetings, attend specialist SEE/RI meetings with companies, and facilitate RI industry collaboration. 60% of CCM's pension fund clients require SEE research, as well as 22% of its charity clients (with ethical restrictions) and 8% of its private clients. Unlike some screening methods, CCM's SEE integration and engagement approach does not impact the investment flexibility and allows shareholders to push for change within companies. Approximately 80% of stocks in the CCM standard charity model have an SEE rating above BB. Cazenove Capital Management Services also has a partnership with Generation Investment Management.

ECCR and Church Investors Group (UK)

The Ecumenical Council for Corporate Responsibility (ECCR) was formed in 1989 to raise the profile of corporate responsibility within the churches. It is a meeting

⁴⁶ Emerson, Jed. (2002). Horse Manure and Grantmaking. Foundation News & Commentary, May/June 2002, p.23. (See www.insp.efc.be/download.php?d=42&f=1)

⁴⁷ World Economic Forum (2006). Blended Value Investing. Capital Opportunities for Social and Environmental Impact. (See www.bfsd.org)

point for faith communities to work, research and learn. The Church Investors Group is an initiative between 11 major church bodies. It has developed a framework for developing a common understanding of the ethical issues affecting companies and provides an opportunity for them to collaborate on engagement.⁴⁸

The F.B. Heron Foundation (US)

The F.B. Heron Foundation in New York envisages its endowment as a 'private community investment trust' and is working to align its market-rate investments with its mission to complement its grantmaking and below-market investments.⁴⁹

Generation Investment Management (US/UK)

Generation Investment Management is an independent, private, employee owned partnership created in late 2004 by David Blood and Al Gore. It invests in long-term, long only, public global equities with a concentrated portfolio of 30-50 companies. Generation integrates sustainability research into fundamental equity analysis as a core principle of the investment process. This research 'is the analysis of shareholder value implications on long-term economic, environmental, social and geopolitical challenges'. The approach is heavily research driven, with bottom-up stock selection. Examples of Generation's thematic research agenda include: poverty, climate change, ecosystem services, biodiversity, pandemics, demographics, migration, public policy and responsible lobbying. 5% of the profitability has been allocated to the Generation Foundation, which supports global, non-profit sustainability initiatives.

Henderson Global Investors (Intl.)

Henderson is a leading international investment management company, which covers all major asset classes, including equities, government and corporate bonds, property, private capital, hedge funds and portfolio management services. Henderson Global Investors manages more than £67.7 billion (as at 31 December 2005) across all asset classes and employs around 900 people around the world. Henderson has an established SRI track record and has managed funds with

social, ethical and environmental dimensions since 1977. In October 2004, Henderson decided to introduce a new investment strategy for its global equity funds – constructing the portfolios entirely around a suite of 10 'Industries of the Future' themes: cleaner energy; efficiency; environmental sciences; health; knowledge; quality of life; safety; social property and finance; sustainable transport; and water management. During 2005, Henderson's Ethical fund was re-launched as the Industries of the Future fund, and by October 2005, this had become 100% invested in the themes.

The Jessie Smith Noyes Foundation (US)

It continues what it has done for years – actively managing the socially responsible investment of its portfolio, together with the operation of a social venture fund and more traditional grantmaking practices.⁵⁰

Joseph Rowntree Charitable Trust (JRCT)(UK)

The investment committee of the JRCT meets twice a year, during which they evaluate the portfolio and, if necessary, write letters of concern to the companies in their portfolio. Generally, they receive responses and have had the opportunity to follow-up when necessary. Unlike most other foundations, the JRCT conducts all of its own screening internally. It started with a screened list produced by EIRIS and made its own modifications to a customised list.⁵¹ This was passed along to the investment manager, with whom the trustees are in close, regular contact. Opportunities to invest in employee-owned businesses have also been considered.

Mistra Foundation (Sweden)

The Mistra Foundation was founded in 1994 with one endowment of €275 million from the Swedish government. Its mission is to invest in strategic environmental academic research that is solution oriented and contributes to sustainable development. Today's value of the endowment is €360 million. As of mid-2005, the Foundation has given €200 million in grants, with a current yearly payout of €23 million (6.5%). Beginning in 2001, Mistra conducted research to screen the methodologies of SRI companies.

48 EIRIS (2005). Investing Responsibly: A practical introduction for charity trustees, p.3 See: www.eiris.org/Pages/TopMenu/Public.htm

49 Emerson, J. (2002). Horse Manure and Grantmaking. Foundation News & Commentary, May/June 2002, p.23 (See www.insp.efc.be/download.php?d=42&f=1)

50 Ibid. p.23. (See: www.insp.efc.be/download.php?d=42&f=1)

51 See: www.eiris.org

The report, Screening of Screening Companies, suggested best practices in the SRI market at the time and pushed transparency and reporting. In conjunction with SustainAbility Ltd., MISTRA is now reviewing the quality of SRI research focusing on materiality and SRI research methodologies. With its enhanced analytics initiative (EAI), MISTRA has pulled together a group of asset owners and fund managers who have committed to allocating a minimum of 5 % of their respective brokerage commission budget to sell-side (research) who are effective at analysing material extra financial issues. EAI aims at differentiating sell-side research to help fund managers to make more informed decisions to enhance the long-term value of their investments.

In 2001, the MISTRA board decided to apply on all assets the 'lowest level of decency'. In addition, it started a positive selection of companies following the best-in-class concept. Some SRI approach is used on 75 % of MISTRA's assets. Positive SRI best-in-class approach and one mandate with only a negative screen implemented. It now covers all equity holdings in Europe and the Swedish band mandates. For more information, see www.mistra.org.

The Rockefeller Foundation (US)

It established the Provenex Fund, a social investment fund that provides critical venture capital to health-related companies developing products and treatments of greatest potential social benefit.⁵²

Tudor Trust (UK)

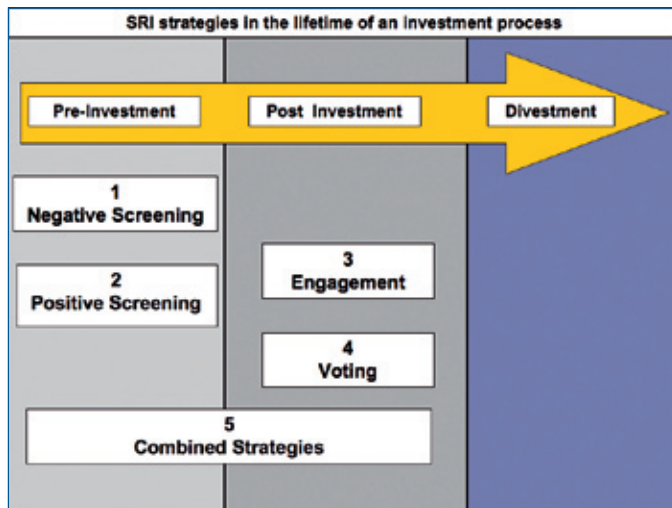
Tudor Trust has operated an RI policy for nearly five years and invests in companies that demonstrate socially responsible values with the potential for sustainable growth in the future. The Trust believes that negative screening may limit opportunities and chooses to invest in social enterprises. An early, innovative initiative was to invest in housing for teachers in East London.

⁵² Ibid., p.23. (See www.insp.efc.be/download.php?d=42&f=1)

II. Strategy options for Foundation Boards

5. What strategies are available?

This section presents the various strategies available to the investor who would like to practise Responsible Investment. There is a diversity of Responsible Investment approaches and strategies in the Responsible Investment field, ranging from various screening to engagement approaches. This Toolkit aims at presenting an impartial, balanced view of the benefits and limits associated with any strategy. While they are presented individually, it is important to note that these strategies are not mutually exclusive. Rather, it could be said that they are complementary as they seek to address CG/SEE issues at different moments in the life of the investment. Screenings are pre-investment actions, while engagement and voting take place when the investor already owns stocks.



The key question for a trustee is: what strategy is most likely to succeed in attaining the goals decided upon by the investor?

NEGATIVE SCREENING

Negative screening is sometimes called exclusion. It consists of barring investment in certain companies, economic sectors or even countries for CG/SEE related reasons.

Negative screening was at the root of the Responsible Investment movement when religious investors in the US and the UK started excluding investments in so-called '*sin stocks*', such as gambling and alcohol. It was again in the spotlight when *CalPers*, California Public Employee's Retirement System, actively campaigned and barred investment in companies with South African activities in the early 1980s to protest against apartheid. A tool at the end of this section lists common exclusion screens. Norms-based screening is often grouped together with negative screening since exclusion can be used at the end of the analysis process. The norms-based approach involves monitoring corporate complicity with internationally accepted norms, such as the *UN's Global Compact*, *Millennium Development Goals*, *ILO Core Conventions* and *OECD Guidelines for Multinational Enterprises*.⁵³

Why use negative screening?

Funds employ negative screening in order to:

- Eliminate a very specific risk from the portfolio;
- Make an ethical statement;
- Communicate in an effective way with members and the general public on ethics;
- Help guard the foundation's reputation; and
- Uphold an investment policy.

Negative screening, especially extensive screening, can potentially increase risk by altering sector and geographic allocations within an investment universe. This could in turn affect a portfolio's performance relative to its benchmark index. Nevertheless, pension funds using norms-based screening report insignificant changes in risk levels.

How do I do it?

Foundations can conduct their own internal screens, and determine their level of tolerance, which can then simply be communicated to asset managers. Alterna-

⁵³ The OECD has guidelines for several environmental and social issues. More information can be found at www.oecd.org.

tively, asset managers can first identify the areas in which negative screening could be applied. There is one major technical difficulty to address when looking at negative screening: many companies may not have their entire business, but only a share of it, in the sector that they wish to exclude.

For tobacco screening, a classic example would be large retailers that sell cigarettes. In this situation, the key issue is for the investor to decide where to draw the line. That share of turnover can again be measured in terms of risk. In addition to screening against activities, another screen is against company performance. Rating agencies and responsible investment analysts may provide this assessment as a service.

Who does it?

Negative screening has historically been popular among foundations such as Wellcome Trust (UK) and Nuffield Foundation (UK), although other foundations, such as the Joseph Rowntree Charitable Trust, conduct negative screens in combination with other types of screens. Some pension funds, particularly in the Netherlands, where Eurosif found that € 184 billion (or about 42 % of total Dutch pension assets) are managed with some form of negative screens.⁵⁴

Tool

Common negative screens used by institutional investors like churches, charities and some pension funds

Armaments and nuclear weapons	Animal exploitation (e.g. fur industry, factory farming)	Animal testing (e.g. pharmaceutical and cosmetic industry)
Alcohol manufacture and promotion	Activities, processes or products that have a major impact on climate change (e.g. automobile, oil and gas industry, road building, etc.)	Genetic engineering
Manufacture and promotion of hazardous substances such as pesticides, chlorine-containing chemicals (e.g. PVC)	Manufacture and promotion of ozone-depleting substances	Tobacco manufacture and promotion
Environmentally damaging practices	Nuclear energy	Oppressive regimes
Poor employment practices	Gambling	Pornography

Source: *Observatoire de la Finance, Responsible Investment in Europe, online executive summary*

POSITIVE SCREENING

What is it?

Positive screening is the selection, within a given investment universe, of stocks of companies that perform best against a defined set of sustainability or CG/SEE criteria.

The most popular form of positive screening is called **'best-in-class'**, where stocks are selected within each sector of a given index, thereby retaining sector balance within the investment universe. A less often used, but equally interesting form is pioneer screening, where funds specialise in the best-performing companies against a specific criterion, such as management of natural resources. Moving away from equity to fixed income, funds applying positive screens to bonds are gradually becoming available as well.

While it is a good strategy to tackle all aspects of CG/SEE, positive screening is rarely used in direct connection with Corporate Governance. If Corporate Governance is the issue that you are concerned with, we encourage you to look at shareholder engagement or proxy voting as strategies of choice. Positive screening is often based on the **triple bottom-line** approach. This means ensuring that companies perform well on social, environmental and economic factors. To understand what criteria are used to rate companies, see the tool at the end of this chapter.

Why use positive screening?

In continental Europe and in the UK, positive screening is viewed as an excellent Responsible Investment strategy. Due to its systematic approach in covering a large number of companies and clarity of practice, it is often considered a more accountable strategy than **engagement**. However, as is the case for negative screening, some investors believe that positive screening reduces investment diversification and therefore contradicts the obligations imposed by fiduciary duty.

Naturally these are issues decided in conjunction with legal advisors taking into account your country's or plan's peculiarities. It could be noted that this assertion is just as true on other common funds such as large-cap funds, mid-caps, etc. Best-in-class selection, specifically, addresses this criticism by maintaining sector balance.

⁵⁴ Socially Responsible Investment among European Institutional Investors 2003

The following explainer goes into further detail.

Explainer: How best-in-class performs compared to benchmark indexes:

Studies¹ show that the size of the investment universe is key in determining how best-in-class may impact performance against a benchmark. In practice, the larger the original investment universe, the less likely there will be a visible impact on the fund performance as related to the benchmark.

On smaller universes, like on smaller countries' stock market indexes, the presence of heavy-weighting stocks (companies with larger-than-average caps) presents a certain danger for positive screening. As these stocks' performance are key in determining the evolution of the overall index, inclusion or exclusion of these large companies represents a significant risk.

On common larger benchmarks though, such as the S&P 500 or MSCI 650, this risk effectively disappears. Thus, when based on large universes, best-in-class portfolios become acceptable investment vehicles in terms of risk.

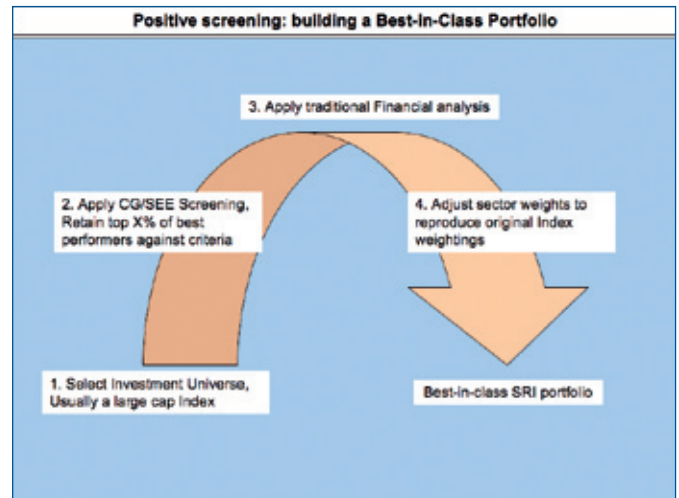
¹ See "International Evidence on Ethical Mutual Fund Performance and Investment Style", by Bauer, Koedijk and Otten, November 2002.

Source: Eurosif.

How do I get started?

Pension funds may buy into existing funds managed with positive screens. They can also buy into funds that track a Responsible Investment index. Additionally, they may ask their managers to apply the screens of their choice.

As a common example of positive screening, the following chart illustrates the creation of a best-in-class portfolio as a 4-step programme:



Source: Eurosif.

Who does it?

Some foundations and other institutional investors in continental Europe run 'test' positive screening portfolios on a small share of their assets. Some examples include the Mistra Foundation in Sweden, and the Pension Funds ABP and PGGM in the Netherlands. Best-in-class funds and other positive screening portfolios are widely available from asset managers everywhere. The Jesse Smith Noyes Foundation has constructed its investment policy to achieve consistency with its mission with positive and negative screening criteria tied to the foundation's mission and grantmaking activities.⁵⁵

Source: ABP Investments

⁵⁵ See www.noyes.org/investpol.html

Tool: Issues and criteria used in screens

For trustees considering screening, this table indicates issues and criteria used in rating companies. Note that this approach is not 'one-size-fits-all', as companies must be rated according to the key issues within their sector. This list can, however, be used to guide positive screens, negative screens and engagement.

Domain	Issues
Human Resources	Integration of human resources issues into corporate strategy, Promotion of labour relations, Encouraging employee participation, Career development, Training and development, Quality of remuneration systems, Improvement of health and safety conditions, Respect and management of working hours.
Environment	Environmental strategy and eco-design, Pollution prevention and control (soil, accident), Development of "green" products and services, Protection of biodiversity, Protection of water resources, Minimising environmental impacts for energy use, Management of atmospheric emissions, Waste management, Management of local pollution, Management of environmental impacts from transportation, Management of environmental impacts from the use and disposal of products/services.
Customers and Suppliers	Product safety, Information to customers, Responsible Contractual Agreement, Sustainable Relationships with suppliers, Integration of environmental criteria in the purchasing process, Integration of social criteria in the purchasing process, Prevention of corruption, Prevention of anti-competitive practices.
Human Rights	Respect for human rights standards and prevention of violations, Respect for freedom of association and the right to collective bargaining, Elimination of child labour and abolition of forced labour, Non-discrimination.
Community Involvement	Promotion of social and economic development, Societal impacts of company's products and services, Contribution to general interest causes.
Corporate Governance	Board of Directors, Audit & Internal Controls, Shareholders' rights, Directors & Key Executives, Remuneration.

OekoVision, a European fund, combines screening to avoid certain activities, behaviours and characteristics ('hard negative' criteria) with a 'vision' on what a sustainable and equitable society might or should look like, and an understanding of which products, processes, services and business models might get us there. The idea is to identify the companies that have an answer for the questions of tomorrow's sustainable society's challenges.⁵⁶

ENGAGEMENT

Engagement can be defined as 'influencing corporate policy by virtue of the position as investor and the associated rights'.⁵⁷

There are three levels of engagement:

- Cultivating general dialogue;
- Taking a proactive stance: 'we would like this specific issue to change for the following reason'; and
- Reactive dialogue: what to do in case of a problem to ensure it does not happen again.

Essentially, engagement differs from screening in that it does not affect the selection of stock, as the strategy takes place after a stock is purchased.

With an engagement approach, every company in the investment universe can be purchased. After purchase, an asset manager will create dialogue teams that will engage with the company on specific, selected issues – usually a few per annum.

Explainer: When to engage?

The British Institutional Shareholders Committee (ISC, whose members are ABI, AITC, IMA, and NAPF) produced a Statement of Principles on Shareholder Activism, in which it states that investors should engage companies when they have concerns about:

- The company's strategy,
- The company's operational performance,
- The company's acquisition/disposal strategy,
- Independent directors failing to hold executive management properly to account,
- Internal controls failing,
- Inadequate succession planning,
- An unjustifiable failure to comply with the Combined Code (UK CG code),
- Inappropriate remuneration levels,
- The company's approach to CSR.

Source: Eurosif

Why use engagement?

First and foremost, for many practitioners, engagement solves the fiduciary duty issue by keeping all investment possibilities open. Traditionally, engagement focuses on Corporate Governance and is, in fact, the strategy of choice when it comes to this issue. A newer and more recent dimension to engagement is the activist stance taken by a number of Responsible Investment investors to push forward the issues that matter to them.

Another significant aspect is the diversity of means that are available to the engaging investor, from writing letters directed at senior management, to filing resolutions at AGMs to voting and, ultimately, divestment. Filing resolutions is considered a good way to warn management that the investor strongly disagrees with

⁵⁶ See: www.oekom-research.de

⁵⁷ Hummels, Willeboordse, & Timmer (2004). *Corporate Shareholder Engagement*, Universiteit Nyenrode.

some of the company's policies. A downside is that the focus of engagement is intrinsically limited by human factors such as size of engagement teams and time allotment, thus potentially covering less ground than positive screening strategies. In addition, many asset managers are reluctant to quantify the result of their engagement activities, thus making assessment of the policies more difficult.

It is often easier for management to address the concerns of a voter than to have grievances aired publicly. And, if management refuses listen to its voters, it is then an opportunity to know to divest

A recent example is the action by the Ecumenical Council for Corporate Responsibility (ECCR) against Shell. The ECCR has actively engaged with Shell since 1994, initially in relation to issues in the Niger Delta, and proposed a resolution for consideration at the 2006 Annual General Meeting.⁵⁸ The Interfaith Center on Corporate Responsibility in the US keeps track of most of the US social resolutions, which is also a useful source particularly to international foundations that hold investments outside of their home territory.⁵⁹

How do I do it?

Shareholders representing foundations have a variety of methods, both public and private, to exert influence:

Private methods

- Raising questions or discussion of social issues in routine meetings between institutional investors and company management.
- Writing to company management about issues of concern.
- Arranging special meetings to discuss such matters.
- Writing to other shareholders to express concerns.
- Joining with other like-minded investors to undertake some or all of the above.
- Informing other investors on the dialogue as to build up pressure.

More public mechanisms

- Attendance at annual general meetings to ask questions.
- Proposing shareholder resolutions.
- Exercising voting rights, e.g. on the adoption of the report and accounts or the re-election of directors.
- Calling an extraordinary general meeting.
- Issuing press briefings.

Source "Just Pensions, A Guide for Trustees and Fund Managers", May 2001

Eurosif transparency guidelines

Eurosif (The European Social Investment Forum) is a pan-European group whose mission is to encourage and develop Sustainable and Responsible Investment and better Corporate Governance. In 2004, they issued Transparency Guidelines, which address engagement among their SRI categories. These guidelines suggest the following:⁶⁰

- Signatories should be clear about who they are and provide background information on the fund, and the fund manager

⁵⁸ See: www.eccr.org.uk/docs/0603_shell_resolution_statement.pdf

⁵⁹ See: www.iccr.org

⁶⁰ Eurosif (2004). Transparency Guidelines. See: www.eurosif.org

- Provide the name of the fund(s) and fund manager to which these guidelines apply.
- Provide contact details for further information regarding the funds.
- What is the size of the fund? In currency at a specified date.
- Where can financial performance history data about the fund be found?
- Provide details of the content, frequency and means of communicating information to investors.
- Briefly describe the corporate responsibility policies of the organisation that managers or promotes the fund(s), or give direction where this information can be located.

Who does it?

Engagement has become a common practice in the UK, especially among pension funds, where £84 billion of pension assets are managed through engagement mandates (Eurosif). Its practice is also on the rise in continental Europe.

Specialised asset managers have dedicated Responsible Investment (or Responsible Investment/CG) teams. They engage on behalf of their customers and supply the resources to address key issues. It is also possible, and more and more frequent, for pension funds to separate engagement from fund management by issuing specific mandates to specialised asset managers. The most advanced specialists report regularly through their websites or dedicated material on the advancement of their engagement activities, including raised issues and outcomes.

Tool: How to engage?

- Trustees should identify which issues, sectors or companies they wish to engage upon within a policy document,
- Decide whether to engage themselves or use external services (as advisors of the fund or as external engagers mandated by the fund),
- Set up the required resources or mandates necessary to engagement,
- Check that reporting about the engagement process is in line with the pension's policy.

Case study: Engagement in practice

Joseph Rowntree Charitable Trust (JRCT)

The JRCT engages directly with companies, support shareholder resolution, and takes part in a group of church investors who engage.

The JRCT works closely with one investment fund manager. Whilst they expect the manager to evaluate the financial risks/opportunities to their investments (e.g. climate change), they do not expect the manager to deal with ethical considerations. That is managed internally and the trustees provide their list of acceptable companies, screened with support from EIRIS, to the investment manager. In general, the JRCT does not invest in funds. However, their investment manager created a new fund, called the Marlborough Ethical Fund⁶¹, which is based on Rowntree's investment policy. Since 1988, the performance of Rowntree's ethically screened returns has been marginally better than the FTSE All Share Index, though not as much as 5%.

PROXY VOTING

What is it?

Every year at companies' annual general meetings (AGMs), shareholders are given the opportunity to vote on a number of issues. Today, given the many scandals such as Enron, Parmalat, WorldCom and others, proxy voting is not just an opportunity, but it is also increasingly being considered a duty for owners to cast their views on a company's decisions and future perspectives. Indeed, the ability for an investor to vote is inherently part of Corporate Governance issues.

Because of the low importance granted to voting in the past, most shareholders tended to vote along with management, or, more to the point, let their asset managers decide whether to vote and what vote to cast. This is beginning to change as shareholders understand the importance and relevance of voting more and more.

⁶¹ Managed by RC Brown. See: www.rcbm.co.uk

Voting today is mostly applied to Corporate Governance, as local regulations limit the type of terms that can pass as resolutions. As a result, when no SEE resolution can be submitted, history shows that shareholder activist groups opposing a company's CSR performance have voted against listed companies' mandatory shareholder approval of accounts and reports as a form of protest.

It should also be noted that institutional investors are increasingly investing beyond their domestic borders. Voting thus becomes *de facto* a cross-border issue. But in this perspective, investors willing to vote abroad will have to be aware that local cultures, regulations and codes on corporate governance differ. Voting policies cannot be one-size-fits-all.

Why vote?

As stated earlier, voting is one of the central means by which shareholders can influence companies in which they have holdings. This strategy can be quite effective, both as a result of the vote's immediate impact on a corporation, as well as through the strong media coverage of cases where conflicts between shareholders and companies led to votes against management.

Voting is often non-binding, but is an excellent means to communicate a shareholder's positions to management. Voting records may only describe part of the relationship between the company and shareowners, but it is an important part and one that is quantifiable and cannot be hidden behind vague policy statements. Ultimately, voting has every reason to become more than a box-ticking exercise. It is an opportunity for concerned investors to get together with other shareholders in order to pursue the goals that they have in common and ensure that their views are represented in the most official way. On the negative side, voting alone (without engagement) lacks the activist side of other strategies. It may succeed in accompanying change, although it is unlikely to bring this change about by itself.

How do you do it?

The key aspect of voting is that a foundation should have a voting policy. A standard example is provided in this section as a case study, as it effectively takes a global approach to cover all issues subject to vote. We

encourage trustees to look to developing their plan's voting policy. On the Corporate Governance side, there are many existing guidelines that may be used as a source:

- The Combined Code, ABI Guidelines, NAPF in the UK;
- Tabaksblat commission report in the Netherlands;
- Rapport Bouton in France;
- SWX Code in Switzerland;
- **OECD Guidelines for Multinational Enterprises;** and
- International Corporate Governance Network (ICGN's) Global Share Voting Principles.

Beyond the policies themselves, numerous voting advisory services have been set up in order to help investors navigate through the ocean of resolutions that are submitted at AGMs all over the world every year. In practice, foundations and other institutional investors may retain direct use of their voting rights, or rely on the asset manager to do so.

Practices vary from country to country and mandate to mandate. As an example, in the UK, most asset managers use voting rights, whereas in the Netherlands they usually are not part of the mandate. Managers throughout Europe are increasing their capacity to tackle voting issues through the creation of Corporate Governance teams, or Responsible Investment teams.

There is not necessarily a 'right way' to vote. For example, many fund managers inform a company that they will vote against an item before an AGM in order to encourage senior executives to change their behaviour. If the company promises to improve, the investor may decide to revise his voting position. And because opposing management may sometimes be a contentious issue due to the complicated issues of confidence that permeate the relationship between shareholder and company management, investors often use abstention as an alternative to voting when opposing a resolution.

Who is doing it?

Due to increasing pressure, voting is becoming more frequent – often with an activist approach. Data suggest that in 2002, little more than half of the shares in

the biggest 350 companies were voted in the UK (one of the highest rates in Europe). Votes against management were rare.⁶²

Trustees should be aware that unions are increasingly active on the voting front. In the UK, the TUC has started carrying out a small number of shareholder campaigns each year; thus far mostly on executive remuneration. The TUC uses its internal Member Trustee Network to advise trustees of certain policy positions and encourage them to instruct their fund manager of that position and related voting opportunities.

Case study:

Hermes' 'International Corporate Governance Principles': Guidelines for voting as primary way for shareholders to participate in the stewardship of companies abroad.

Hermes is an institutional fund manager independent of any broader financial services group. They invest funds on behalf of over 230 clients including pension funds, insurance companies, government entities and financial institutions, as well as charities and endowments.

Hermes based its principles on those of the International Corporate Governance Network (ICGN), which were derived from the OECD's Principles on Corporate Governance (1999/2004).

They are meant to guide Hermes' voting decisions and apply to investments outside the UK. Hermes acknowledges that proxy voting is the primary way for shareholders to assume their responsibilities as owners outside their home market.

Key principles highlighted are:

1. Corporate objective: the overriding objective of the corporation is to optimise shareholder return.
2. Communications and reporting: accurate reporting by companies.
3. Voting rights: one vote per share and a duty to vote for fiduciary investors.

4. Corporate boards: accountability of the board of directors to shareholders and appointment of independent directors, among other things.
5. Corporate remuneration policies: in line with the interests of shareholders.
6. Strategic focus: shareholder approval for major strategic shifts.
7. Operating performance: optimisation over time.
8. Shareholder returns: optimisation over time.
9. Corporate citizenship: respect of applicable laws and co-operation with stakeholders.
10. CG implementation: application of local corporate governance codes.

Tool: Establishing and implementing proxy voting guidelines

- Develop proxy voting guidelines that clearly identify voting criteria, and provide voting instructions regarding CG/SEE issues (see Hermes example).
- If the pension plan does not itself, obtain the services of a proxy voting service and ensure that the plan's Statement of Investment Principles and Guidelines are applied in voting proxies.

Source: SHARE, Implementing Socially Responsible Investment Policies and Practices in your Pension Plan

COMBINING STRATEGIES

As we have shown throughout this section, certain strategies may be more effective than others in tackling specific issues. In practice, applying a combination of strategies may enable an investor to reap the benefits of Responsible Investment's possibilities and ensure that its assets are protected in an efficient manner, for example:

- Negative screening is applied to sectors that the investor in no way wishes to support;
- Positive screening is applied to ensure that the investor's views are represented over all of its investments; and
- Engagement is applied to tackle specific issues and create a working relationship with the investee company that enables collaboration on and tracking of the evolution of those issues.

⁶² Source: The Economist, Oct 31st 2002.

Classic examples of combined strategies include:

- Funds tracking sustainable indices, which apply a combination of positive and negative screening in order to create their investment portfolios. Such fund products are quite popular with institutional investors. Examples include FTSE4Good and DJSI.
- Another example is where investors create a best-in-class portfolio for SEE issues and track and improve Corporate Governance matters through an engagement approach.

KEY TERMS

Best-in-class
Engagement
Negative screening
OECD Guidelines for Multinational Enterprises
Positive Screening
Sin stocks
Triple Bottom-Line

6. What are emerging trends in Responsible Investment?

COLLABORATIVE ENGAGEMENT AND VOTING

There is a growing trend within the responsible investment community to practice **collaborative engagement**. This type of cooperation among foundations, investors, pension funds, asset managers and others is widely justified by economic constraints, the steep learning curve of developing an engagement practice and the clout associated with pooling investor power in order to achieve economies of scale.

In practice, collaboration takes many forms:

- It may mean pooling resources on researching issues. A typical example would be the Institutional Investor's Group on Climate Change (IIGCC), which brings together investors and asset managers willing to research and share experiences on the effects of climate change on corporations.
- It may also mean pooling shareholder power. This is largely practised by pension funds in covering CG

issues. Pension fund groups such as the National Association of Pension Funds (NAPF) in the UK or the Dutch pension funds corporate governance research foundation (SCGOP) in the Netherlands are active on this front. There are also larger, international investors groups, such as the International Corporate Governance Network (ICGN), issue guidelines and communicate on best practices to their members and to the wider public.

- Collaborative voting has been common but discrete among institutional shareholders on traditional and CG issues. The internationalisation of portfolios leads to an increased need for understanding of and assistance on issues related to investments abroad.
- A related means to pool resources for investors is to pool targets: selecting a single issue that affects a large number of companies, such as accounting of stock options and campaigning on it at all AGMs.
- Unions too have been active internationally on this front. In the UK, the TUC is looking at organising multiple campaigns every year using its wide trustee network. Collaborative engagement is a trend on the rise and trustees and investors can look forward to the benefits associated with it by discussing opportunities with their peers and actors in the fund industry.

INTEGRATION

Integration is a growing practice among both mainstream and Responsible Investment-specialised asset managers to incorporate CG/SEE factors into traditional financial analysis as a means to manage risks as well as identify potential out-performance. This approach is based on the premise that extra financial criteria can materially impact long-term corporate performance. In addition, superior management of such factors can be an indication of management quality. Integration, for example, explores how extra-financial factors such as global climate change will impact upon corporate performance over a long-term period. These asset managers are hoping to attract a large, mainstream investor audience with this integrated approach.

The case for integration

Practitioners tout three reasons for the emergence of integration:

- To include a normative judgement rather than screening, which allows the integration of the most material value drivers on a sector and company basis;
- To generate unique insight from the market by looking at under-analysed themes; and
- To take into account increasing regulatory pressure on the social and environmental front.

Integration is an important and welcome sign that CG/SEE issues are entering the mainstream. Investors who do not have the interest or ability to participate themselves in proxy voting or work with screened funds may find firms that engage in integrated investment an appropriate route to pursue. At the fund manager level, integration allows managers to engage companies on the basis of extra-financial issues not historically considered by traditional analysts or management. For asset owners who are interested in pursuing long-term investment strategies as well as approaches to fulfilling their social responsibility, integration offers a form of capital management that is engaged in a 'deep' way with the companies within a given portfolio. Furthermore, funds managed on an integrated basis, such as Generation Investment Management, create unified teams of analysts with both sustainability and financial expertise, as opposed to the traditional approach of separating financial analysis from sustainability considerations.

How do I do it?

The assessment of social and environmental risks can be used both in stock picking and selling. Since the teams carrying out the CG/SEE assessment can be the same as the ones practicing CG/SEE engagement at specialist investment houses, the analysed information also has an impact on dialogue with companies. In fact, CG/SEE issues simply become part of the 'general picture'. When going to a meeting with a company, a mainstream financial analyst may join the manager's Responsible Investment analyst. Eurosif believes that in the future, instead of having two teams, it will become more likely for asset managers to include CG/SEE assessment into the job description of mainstream analysts.

Case study: UN Global Compact

Through their "Who Cares Wins" initiative, the Global Compact is bringing together financial institutions to jointly publish recommendations to better integrate environmental, social and governance issues in analysis, asset management and securities brokerage. Members of the initiative include ABN Amro, Aviva, AXA Group, Banco do Brasil, Bank Sarasin, BNP Paribas, Calvert Group, CNP Assurances, Credit Suisse Group, Deutsche Bank, Goldman Sachs, Henderson Global Investors, HSBC, Innovest, ISIS Asset Management, KLP Insurance, Morgan Stanley, RCM, UBS and Westpac.

"The report's recommendations can be summarized as follows:

- Analysts are asked to better incorporate environmental, social and governance (ESG) factors in their research where appropriate and to further develop the necessary investment know-how, models and tools in a creative and thoughtful way.

Based on the existing know-how in especially exposed industries, the scope should be expanded to include other sectors and asset classes. Because of their importance for sustainable development, emerging markets should receive particular consideration and environmental, social and governance criteria should be adapted to the specific situation in these markets. Academic institutions, business schools and other research organisations are invited to support the efforts of financial analysts by contributing high-level research and thinking.

- Financial institutions should commit to integrating environmental, social and governance factors in a more systematic way in research and investment processes. This must be supported by a strong commitment at the Board and senior management level. The formulation of long-term goals, the introduction of organisational learning and change processes, appropriate training and incentive systems for analysts are crucial in achieving the goal of a better integration of these issues.

- Companies are asked to take a leadership role by implementing environmental, social and corporate governance principles and policies and to provide information and reports on related performance in a more consistent and standardised format. They should identify and communicate key challenges and value drivers and prioritise environmental, social and governance issues accordingly. We believe that this information is best conveyed to financial markets through normal investor relation communication channels and encourage, when relevant, an explicit mention in the annual report of companies. Concerning the outcomes of financial research in this field, companies should accept positive as well as critical results.
- Investors are urged to explicitly request and reward research that includes environmental, social and governance aspects and to reward well-managed companies. Asset managers are asked to integrate research on such aspects in investment decisions and to encourage brokers and companies to provide better research and information. Both investors and asset managers should develop and communicate proxy voting strategies on ESG issues as this will support analysts and fund managers in producing relevant research and services.
- Pension fund trustees and their selection consultants are encouraged to consider environmental, social and governance issues in the formulation of investment mandates and the selection of investment managers, taking into account their fiduciary obligations to participants and beneficiaries. Governments and multilateral agencies are asked to proactively consider the investment of their pension funds according to the principles of sustainable development, taking into account their fiduciary obligations to participants and beneficiaries.
- Consultants and financial advisers should help create a greater and more stable demand for research in this area by combining research on environmental, social and governance aspects with industry level research and sharing their experience with financial market actors and companies in order to improve their reporting on these issues.
- Regulators are invited to shape legal frameworks in a predictable and transparent way as this will support integration in financial analysis. Regulatory frameworks should require a minimum degree of disclosure and accountability on environmental, social and governance issues from companies, as this will support financial analysis. The formulation of specific standards should, on the other hand, rely on market-driven voluntary initiatives. We encourage financial analysts to participate more actively in ongoing voluntary initiatives, such as the Global Reporting Initiative, and help shape a reporting framework that responds to their needs.
- Stock exchanges are invited to include environmental, social and governance criteria in listing particulars for companies as this will ensure a minimum degree of disclosure across all listed companies. As a first step, stock exchanges could communicate to listed companies the growing importance of environmental, social and governance issues. Similarly, other self-regulatory organizations (e.g. NASD, Financial Services Authority), professional credential-granting organizations (e.g. Association for Investment Management and Research), accounting standard-setting bodies (e.g. Financial Accounting Standards Board), public accounting entities and rating agencies and index providers should all establish consistent standards and frameworks in relation to environmental, social and governance factors.

- Non-Governmental Organisations (NGOs) can also contribute to better transparency by providing objective information on companies to the public and the financial community.”⁶³

A more recent initiative by the UN, announced in April 2006 by UN Secretary General Kofi Annan, is the **‘Principles for Responsible Investment’**.

The Principles were developed during a nearly year-long process convened by the UN Secretary-General and coordinated by the UN Environment Programme Finance Initiative (UNEP FI) and the UN Global Compact. The heads of leading institutions from 16 countries, representing more than US\$2 trillion in assets owned, signed the Principles at a special launch event at the New York Stock Exchange. Signatories included asset owners, investment managers, and professional service partners.

As Kofi Annan stated, ‘These Principles grew out of the understanding that while finance fuels the global economy, investment decision-making does not sufficiently reflect environmental, social and corporate governance considerations – or put another way, the tenets of sustainable development ... Developed by leading institutional investors, the Principles provide a framework for achieving better long-term investment returns and more sustainable markets. I invite institutional investors and their financial partners everywhere to adopt these Principles.’

The six Principles are as follows⁶⁴:

- (1) We will incorporate environmental, social and corporate governance (ESG) issues into investment analysis and decision-making processes.
- (2) We will be active owners and incorporate ESG issues into our ownership policies and practices.
- (3) We will ask appropriate disclosure on ESG issues by the entities in which we invest.

(4) We will promote acceptance and implementation of the Principles within the investment industry.

(5) We will work together to enhance our effectiveness in implementing the Principles.

(6) We will each report on our activities and progress towards implementing the Principles.

These Principles are underpinned by a set of 35 possible actions that institutional investors can take to integrate environmental, social and corporate governance (ESG) considerations into their investment activities.

⁶³ The Global Compact (2005). *Who Cares Wins*. Connecting Financial Markets to a Changing World, p.ii – iv.

⁶⁴ For more details, see: www.unpri.org/principles/

ENHANCED ANALYTICS

The Enhanced Analytics Initiatives (EAI)⁶⁵ is an international collaboration between asset owners and asset managers aimed at encouraging better investment research, in particular research that takes account of the impact of extra-financial issues on long-term investment. The EAI is working to advance greater practice of analytics that integrate extra-financial analysis into analysts' frameworks. The Initiative currently represents total assets under management of €757 billion (US\$ 920 billion).

KEY TERMS

Millennium Development Goals
UN Global Compact

EFIs are best described as fundamentals that have the potential to impact companies' financial performance or reputation in a material way, yet are generally not part of traditional fundamental analysis. For example, future political or regulatory risks, the alignment of management and board with long-term company value, the quality of human resources management, risks associated with governance structure, the environment, branding, corporate ethics and stakeholder relations.

EFIs generally have one or more of the following characteristics:

- 1 They tend to be *qualitative* and not readily quantifiable in monetary terms (e.g. corporate governance, intellectual capital);
- 2 They relate to *externalities* not well captured by market mechanisms (e.g. environmental pollution);
- 3 They relate to wider elements of the *supply chain* (e.g. suppliers, products and services);
- 4 They are the focus of *public concern* (e.g. GMOs);
- 5 They have a medium to *long-term* horizon (e.g. global warming); and
- 6 The *policy and regulatory framework* is tightening (e.g. greenhouse gas emissions).

⁶⁵ See www.enhanced-analytics.com

III. Guide for Foundation CFOs: Getting Started

7. What should I ask asset managers and consultants about Responsible Investment?

Foundations normally do not have their own asset managers (AMs), but give mandates to reputed external AMs, who thus become key players in enabling a Responsible Investment policy. Selecting the right manager is therefore critical.

Trustees will want to talk to their current managers, as well as to their investment advisor. This chapter offers a Case Study illustrating how to create a responsible investment policy with current managers as well as a Tool-questionnaire.

Today, few AMs ignore responsible investment-related issues in their offer. Yet how they tackle these matters opens the door to a myriad of different strategies. Some AMs have been leaders in developing products and services to cater to foundations and are known for their risk-oriented focus, being 'conservative' in their advice in the true sense of the word, i.e. conserving the value of the endowment. Not all of them are willing to explore the new trends in responsible investment developments, even if many of these responsible investment products by design aim at risk reduction.

Responsible Investment is now becoming increasingly accepted as a style of investment, and thus part of the offering of AMs working with foundations. And, the mainstream asset manager has been following suit. Depending upon their primary markets, they will usually concentrate on one particular Responsible Investment strategy.

As further signs of the evolution in this field, dedicated Responsible Investment and Corporate Governance teams of analysts are becoming standard practice as specialists and leading fund managers have the means and the information to implement a Responsible Investment policy. In fact, some of those companies even offer specialty engagement and voting services independent of the actual management of funds.

While the product range and capacity is increasing on the asset management side, trustees should ensure that their suppliers can come up with the most appropriate service. Trustees should start to ask AMs the questions presented in the tool below in order to verify their responsible investment capacity.

Case study: How to collaborate with existing managers in developing Responsible Investment

An interesting illustration of the relationship between a pension fund and the asset manager can be gleaned from the recently created Fonds de Réserve des Retraites in France (Retirement Reserve Fund, FRR). The Fund's board wishes to integrate CG/SEE issues into the management of a large share of its assets. Having given mandates to various asset managers for its different asset classes, the FRR has decided to collaborate with each of them, post mandating, in order to decide the best ways to achieve this. The FRR raises four key issues:

- Collection, analysis and quality of CG/SEE-related information;
- Integration into the investment process;
- How to deal with conflicts of value and arbitraging with risk and return; and
- AM's strategy and costs.

The FRR expects this process to take place over the next few years before mandates are renewed. This example shows that dialogue around Responsible Investment is not only possible, but also necessary in order to best define the contours of an appropriate Responsible Investment policy for each pension fund.

Tool-questionnaire: Criteria for the evaluation of fund managers

- Does the AM have dedicated teams (responsible investment/CG) and what is the size of the staff?
- What financial resources are dedicated to responsible investment management?
- What are the additional costs of implementation of a Responsible Investment strategy?
- Do managers integrate CG/SEE material risk as a part of regular decision-making?
- What is the AM's track record/history of Responsible Investment involvement?
- What are the AM's engagement and voting activities?
- What are the AM's proposed screening processes and methodologies?
- Does the AM collaborate with other interested parties: other pension funds or fund managers, rating agencies, NGOs, collaborative organisations, etc.?
- What are the AM's reporting practices in terms of frequency and quality?
- Further references to asset manager selection:
- As a good illustration of contemporary thinking, the USS Pension Funds 'How to Be a Responsible Pension Fund' presents a clear case for evaluating a Fund Manager's responsible investment capacity and services.
- The Just Pensions May 2001 'Guide for Trustees' offers similar advice on engagement practices.
- Does the manager express a genuine interest and possess the ability to integrate the foundation's screening criteria and SEE/CG criteria into their investment processes?
- How do the managers' sources of adding value and management of undesired risk intersect with the foundation's screening criteria?
- Can the manager demonstrate their ability to successfully integrate their process through the construction of a model portfolio?

8. How can I integrate CG/SEE into investment principles?

Once you have decided to begin a discussion with your investment professionals on CG/SEE, you may want to incorporate your responsible investment concerns within a specific guideline of investment principles.

In the case of pension funds, national legislations are increasingly requiring pension funds to publish Statement of Investment Principles (SIPs). This is not (yet) the case for foundations.

Beyond legal obligation, the aim of producing investment principles is to ensure that clear directions are integrated into the mandates that are given out to fund managers – and henceforth that these directions are respected.

Tool: How you can integrate Responsible Investment into your investment principles

- Amend the governing documents of the endowment's investment plan to provide explicit direction to trustees to engage in socially Responsible Investment practices.
- Specify your expectations and commitments from/to companies as a shareholder in your governing documents.
- Develop a Statement of Investment Principles that includes guidelines for Responsible Investment that give explicit authorisation to consider non-financial criteria.
- Develop and follow written procedures for developing investment policies and guidelines, selecting investments, advisors and agents, consulting with beneficiaries and making other investment-related decisions.
- Establish procedures for the implementation and timely review of investment policies.
- Ensure safe risk/return and diversification levels.

Case study: The UK Environmental Agency

The UK environmental agency has an investment policy that is defined in such a way that it seeks to align it with their environmental role. Their aim is to 'become recognised as a leader in the public sector in financially robust environmentally responsible investment and pension fund management by 1st April 2007'.⁶⁶ In their 'Environmental overlay strategy', they outline a series of points to ensure that the strategy and policies for investment 'contribute to creating a "greener" business world', some of which are highlighted below. Foundations can also learn from these principles:

UK Environmental Agency Active Pension Fund

Fiduciary duty

We will fulfil and comply with our overriding fiduciary duty to maximise investment returns on behalf of the pension fund members. As a result of which we affirm that we will assess and take account of existing and future financial risks and opportunities from environmental issues (e.g. from climate change, cost of pollution clean ups and the exploitation of green technology and services).

Statement of Investment Principles

When preparing and maintaining the SIP, we will be mindful of our overall corporate strategy (e.g. "greening" business) and corporate environmental governance policies (e.g. encouraging company environmental reporting and disclosure of environmental risks and performance), A revised SIP will be developed with the benefit of research into best practice in respect of environmental issues from other pension funds, and will be published, and reviewed annually by the Pensions Committee.

Investment strategy

Our investment strategy will seek to take account of the relationship between good environmental management and long-term sustainable business profitability.

We will seek to overlay this environmental strategy across our investment portfolio that recognizes there are different approaches, constraints, risks and opportunities and potential benefits in respect to its application to equities, bonds, gifts, property and private equity.

Our main influence will be through our strategic asset allocation, manager structure, manager selection, performance benchmarks, monitoring and reporting – and not be getting involved in the day-to-day investment decisions, which is the role of our asset managers.

We will encourage our fund managers to use research on various environmental risk and/or 'green' performance rating/ranking tools to identify and avoid financial risks that may be attributable to environmental issues (e.g. climate change) and that could negatively impact on investment returns.

We will, through monitoring their performance, ask our fund managers to explain and financially justify any investment decisions, for example, on stock selection, which in its view are environmentally controversial. We will favour investing on a positive 'best in class' selection basis and by the use of engagement, in preference to negative screening.

⁶⁶ See: www.environment-agency.gov.uk/commondata/acrobat/environmental_overlay_998382.pdf

9. Practical steps: Walk the talk

To conclude this section and the PRIME Toolkit, the Bellagio Forum and Eurosif propose the following steps for trustees to use in their journey to successfully implement CG/SEE issues within their plans.

Tool: What is the pathway to integrate CG/SEE issues into a foundation's management mandate for its endowment?

1st STEP: Discuss

- Encourage other trustees in your plan to read the toolkit and use other means to become familiar with responsible investment.
- Encourage discussion of responsible investment at trustee meetings.
- Find out about other existing responsible investment activities by foundations, e.g. through the European Foundation Centre (EFC)
- Discuss legality with lawyers at your plan.
- Discuss existing possibilities with your current Asset Managers as well as other specialists in the market. Find out about their voting practices and records.
- Inquire about responsible investment collaboration possibilities, such as collaborative engagement or voting.

2nd STEP: Promote

- Use your power as a trustee to push for implementation of a responsible investment policy when your board discusses endowment investment policies
- Seek commitment from other trustees and from the Executive Board.

3rd STEP: Decide

- Decide which CG/SEE issues are most relevant to your foundation. This could be a means to approach Asset Managers and see how they can fulfil your needs.
- Based on your discussions, decide what responsible investment strategies best suit your plan.
- Link responsible investment to foundation's mission, aims and objectives.
- Decide which amount of the plan's assets to initially allocate to your strategy. This could mean:
 - running a test responsible investment programme by creating a fund,
 - running a test responsible investment programme by buying into existing funds,
 - joining collaborative initiatives (as proposed in the Bellagio Forum).

4th STEP: Draft

- Participate in drafting or redrafting your foundation's Investment Principles or Code of Prudential Investment.
- Make sure that it specifies the importance of CG/SEE issues.
- Participate in drafting or redrafting your plan's voting policy.
- Communicate these documents to your asset managers and make them public.

5th STEP: Follow-up

- Ensure that you receive proper reporting and information from your asset managers on fund performance, engagement records, voting records and policy choices.
- Review performance of asset managers.
- Review policy in light of experience: step up to the next level.

Case study: The I.DE.A.M. Eurosocietal Fund for Foundations

The Finance Working Group of the Bellagio Forum held a series of meetings in 2004 and 2005 to define the best criteria that should guide an investment of endowed financial resources in a most appropriate way. The MISTRA foundation sponsored specific work by Ivo Knoepfel of Swiss consultancy OnValue, who reviewed the various options and possibilities and presented his recommendations to the Bellagio Finance Working Group in the fall of 2005. The objective was to define a set of rules and conditions that a company would have to adhere to if a special fund reflecting the criteria set by foundations.

The working group defined a broad spectrum of criteria that – based on the PRIME survey and work – would best reflect the concerns and ambitions of European endowed foundations. These criteria covered both environmental and social demands, but most importantly governance issues, as it was on the “good governance” front most foundations had concerns with reputational risk.

The Foundation for Business and Society – working with InSpire Invest - defined on that basis a set of criteria and their weighting that reflected the risk attitude of a case foundation, exemplified by MISTRA.

In addition, the Bellagio Working Group suggested to include additional safety measures to reduce any potential reputational risks, and chose to focus on the Global Compact Principles. It looked to the Global Compact Office at the UN in New York, to identify ways to make a special screen for that purpose.

The tool used for that purpose, called Global Compact Plus, has been designed by Innovest Strategic Value Advisors to assist investors in assessing companies’ relative capabilities and strategic positioning in addressing the competitive risks, challenges, and opportunities posed by the 10 Principles of the United Nations Global Compact.

The Global Compact Screen guarantees that no company with serious breach of any of the 10 basic principles underlying the Global Compact would be taken into a portfolio without a legitimated reason for do-

ing so. Based on this recommendation by the task-force, I.DE.A.M., the SRI subsidiary of the Credit Agricole Group, became the first European Asset Manager to systematically take in this Global Compact Compliant screening of companies in all its activities.

I.DE.A.M. has developed a specific test fund for the Bellagio Project, where the criteria of the PRIME guidelines and the Global Compact Screen were combined. The prototype fund is built on the already successful Eurosocietal Fund by I.DE.A.M., which manages more than 1.3 billion Euros under various SRI mandates.

I.DE.A.M. implemented the Bellagio recommendations into this long-running fund, and created a special class in its Luxembourg-registered fund to meet the needs of European foundations. The MISTRA Foundation of Sweden decided to be the first Foundation to invest in this model and has so far invested EUR 20 mill in the Fund that follows these criteria and investment rationale:

- companies which apply socially responsible and good corporate governance principles and develop pro-active environmental policies tend to emerge as leaders in their peer group industries;
- the shares of these companies should outperform the market in the long term,
- a dedicated SRI analysis team is an essential tool for in-depth assessment of the fundamental value of companies, including all intangible assets;
- in the present market conditions, the most efficient way of identifying these companies is to take advantage of the increasing amount of specialist third-party research in order to recognize those companies requiring in-depth dedicated research;
- SRI-favoured companies should then be screened using financial criteria to adapt to financial market volatility (and to eventually suspend investment in those whose shares are temporarily over-priced, relative to their business prospects).

Under these assumptions, the Fund reflects **a new investment style focused on out-performance for long-term investors.**

This SRI approach enhances pure financial data with synergetic inputs. It offers long-term investors like

endowed foundations valuable insights, not yet fully taken into account by the equity markets, concerning the medium-term structural well-being of companies that they invest in; focused on **sustainable growth, relationships with stakeholders, respect for the environment and business ethics**. Company evaluations are based on a „multi-criteria“ analysis, such as Human Resources, Total Quality, Shareholder Value, Environment Policy, and Community Relations, which takes into account:

- corporate governance criteria, based on an interpretation of in-depth analyses provided by **established data providers** as well as direct research;
- societal and Environmental criteria based on interpreted research results;
- weak signals analysis identified by I.DE.A.M's own knowledge management model ("Spider").

The integration of these several sources is realized by Inspire Invest research team.

A comprehensive performance attribution system enables I.DE.A.M to clearly demonstrate the SRI-driven origin of the outperformance that we achieve. **The ultimate goal is Risk and Intangible Value Assessment (RIVA) of the company for investors.**

Risk control in portfolio construction: Avoiding the reputational risk danger.

The Prototype Fund initiated by the Bellagio Forum members focuses strongly on controlling risk, as the PRIME survey showed that it was one of the main concerns for endowed foundations.

In the Prototype Fund, the fund manager is responsible for applying the investment process and building the portfolio in such way as to match the risk constraints of the client (tracking error).

The research outputs lead directly to stock ranking and weighting in the portfolio. Typically, the stocks identified as positive are overweighted by 0.30 to 1 % depending on portfolio constraints, leading to a global overweight based on the concept of sustainable growth at market price. By the same token, negatively graded stocks are excluded or underweighted and neutral stocks are used to monitor the risk process of

the portfolio. Risk profile techniques are applied to all three categories of stock in order to reduce systematic risk and match customized active risk constraints.

Risk control aims at matching both the country and the sector distribution of the benchmark.

Typical portfolio characteristics

- 100 % permanent exposure to the market;
- well diversified, e.g. 130–160 in Europe or 250–350 in Global portfolios;
- neutral country and sector allocation relative to the benchmark;
- low active risk (tracking error of 1 to 3 %);
- targeted out-performance: 1 to 3 % p.a.;
- expected information ratio: 0.7 to 1.5 %.

Glossary

Asset Corpus: refers to the income-generating assets of the Foundation.

'Best-in-class' screening: A specific approach within positive screening where the leading companies with regard to SEE criteria from each individual sector or industry group are identified and included in the portfolio (Eurosif).

Blended Value Investing: 'Traditionally, we have thought of value as being either economic (and created by for-profit companies) or social (and created by nonprofit or non-governmental organizations). What the Blended Value Proposition states is that all organizations, whether for-profit or not, create value that consists of economic, social and environmental value components—and that investors (whether market-rate, charitable or some mix of the two) simultaneously generate all three forms of value through providing capital to organizations.'⁶⁷

Collaborative engagement: An engagement strategy conducted in cooperation by multiple investors or asset managers in order to gain leverage (Eurosif).

Corporate Governance (CG): 'Corporate Governance covers the accountability and control mechanisms that govern the relationships among shareholder, management and stakeholders of a company. In essence, it's about creating an accountable process rather than about setting goals and standards, thus helping to prevent major crises. Among other things, it defines:

- Board composition,
- Board remuneration,
- Shareholders' rights to information,
- Shareholders' rights to submit resolutions at Annual General Meetings (AGMs),
- Shareholders' voting rights (such as one share-one vote-one divided principle),
- Control mechanisms (including risk management)' (Eurosif).

DJSI – Dow Jones Sustainability Group Indexes:

Launched in 1999, the Dow Jones Sustainability Indexes are the first global indexes tracking the financial performance of the leading sustainability-driven companies worldwide.

(See www.sustainability-index.com)

Domini Social Index 400

(See www.domini.com/dsi400/index.htm)

Eco-efficiency: The competence of the company in using environmental resources sparingly in its production.

Engagement: A long-term process of dialogue with companies which seeks to influence company behaviour in relation to their governance, social, ethical and environmental practices (Eurosif).

FTSE4Good: The FTSE4Good Index Series has been designed to measure the performance of companies that meet globally recognised corporate responsibility standards, and to facilitate investment in those companies. Transparent management and criteria alongside the FTSE brand make FTSE4Good the index of choice for the creation of Socially Responsible Investment products.

(See: www.ftse.com/ftse4good/index.jsp)

Integration: The inclusion by asset managers of CG/SEE-risk into traditional financial analysis (Eurosif).

International Labour Organization (ILO) Core Conventions:

Eight ILO Conventions have been identified by the ILO's Governing Body as being fundamental to the rights of human beings at work, irrespective of levels of development of individual member States. These rights are a precondition for all the others in that they provide for the necessary implements to strive freely for the improvement of individual and collective conditions of work:

Freedom of association

(1) Freedom of Association and Protection of the Right to Organize Convention, 1948 (No. 87)

(2) Right to Organize and Collective Bargaining Convention, 1949 (No. 98)

The abolition of forced labour

⁶⁷ See www.blendedvalue.org

- (3) Forced Labour Convention, 1930 (No. 29)
- (4) Abolition of Forced Labour Convention, 1957 (No. 105)

Equality

- (5) Discrimination (Employment and Occupation) Convention, 1958 (No. 111)
- (6) Equal Remuneration Convention, 1951 (No. 100)

The elimination of child labour

- (7) Minimum Age Convention, 1973 (No. 138)
- (8) Worst Forms of Child Labour Convention, 1999 (No. 182)

(See: www.ilo.org)

Loan Guarantee (Short Primer): In a standard loan agreement, the borrower provides some manner of collateral, giving the lender a claim on the borrower if he or she cannot meet the obligations of the loan. In collateralized loans, the borrower's assets are pledged to satisfy the lender in the event that the borrower cannot meet the obligation. (In a micro-credit context, the collateral may not be property or assets but "social collateral," or the future loans of others in a lending group.) In a situation where a borrower may not have sufficient collateral, another party may pledge assets or its general credit to meet the loan obligation if the borrower defaults. The party pledging the assets is the guarantor, and often it places securities or other assets in an account that can be easily accessed by the lender in the event of a collateral call. This is called a loan guarantee or credit enhancement.

In some situations, an entity perceived to carry a lot of risk (such as an MFI or a young company) can reduce its cost of borrowing by having an entity with a lower risk rating (such as a foundation or investor) guarantee all or part of the loan; that added safety should then lower the cost of borrowing, though the entity directly benefiting from the loan guarantee often must pay a fee to facilitate the arrangement. Beyond lower-cost borrowing, a loan guarantee encourages follow-on financing both by removing some of the borrower's risk but also by signaling the borrower's quality.

Guarantee arrangements vary dramatically. Many government-backed programs, for example, are guaranteed by the full-faith and credit of the country's government, in which case the guarantor does not specify any assets to serve as collateral, though a borrower can

still make a general claim against the guarantors. Most guarantee arrangements require that specific assets be pledged. Often pledged financial assets are segregated from a guarantor's other assets in a special bank or brokerage account, and real assets will be subject to some form of contract determined by the guarantee agreement.

If the guarantor pledges financial assets, the guarantee agreement may limit the kinds of investments that are eligible for investment, but the guarantor receives the benefits of any capital appreciation (or the exposure to any losses) generated by the investments. Accordingly, many guarantee agreements allow the guarantors to earn market-rate returns on their investments while facilitating further third-party investments in the borrower. Since the guarantor is exposed to at least part of the borrower's risk, the guarantor does accept a higher risk for the returns that the assets would generate without securing the borrower's loan. Guarantees are commonly governed by a relatively standardized arrangement called a standby letter of credit, which can be issued by banks to enable a guarantor easily to guarantee the debt of a borrower. Banks may extract fees for maintaining guarantee arrangements, and a borrower may compensate the guarantor for accepting additional risk.

Loan guarantees have been a feature of lending and international development for years and blended value investors have explored a variety of innovative ways to apply guarantees in their investments. Dating back at least as far as 1984, when ACCION International launched its Bridge Fund (which offered loan guarantees that helped Latin American MFIs borrow from commercial lenders), investors have pledged their assets to guarantee and thereby accelerate the work of blended value-generating projects.⁶⁸ When applied to blended value investments, a guarantee arrangement can generate social returns by facilitating and reducing the cost of financing for blended value projects. Furthermore, a guaranteeing entity may provide technical assistance or consulting to help the investment succeed.

⁶⁸ More information on the Latin American Bridge Fund and its successor, the Global Bridge Fund, can be found in ACCION's periodic publication *InSight*. Number 15, published in September 2005, is devoted to those funds and the concepts of loan guarantees. It can be downloaded at www.accion.org/insight/.

Characteristics of a Blended Value Loan Guarantee

While the loan guarantee structure is versatile, it can only be applied to a project that can be leveraged with debt; that is, the project must have relatively predictable cash flows. A loan guarantee might be used to launch a new project that may be somewhat speculative. The history of microfinance bond offerings and loan guarantees are profoundly intertwined (as noted in the section of this paper addressing innovations in debt finance), and loan guarantees were essential to the first issues as well as some of the most recently offered securities.

Loan guarantee arrangements are suitable in a variety of situations. Specifically, they can be useful to spur investment in new financial products, the likes of which mainstream commercial lenders have never seen. Another advantage of loan guarantees is that they can reduce exposure to currency fluctuations and, in the process, shift the exposure from the borrower to the guarantor. Under this arrangement, one only needs to convert one currency to another in the event of a default that results in a capital call.

Millennium Development Goals: The eight Millennium Development Goals (MDGs) a blueprint agreed to by all the world's countries and all the world's leading development institutions. They have galvanized unprecedented efforts to meet the needs of the world's poorest. They are to:

- (1) Eradicate extreme poverty and hunger
- (2) Achieve universal primary education
- (3) Promote gender equality and empower women
- (4) Reduce child mortality
- (5) Improve maternal health
- (6) Combat HIV/AIDS, malaria and other diseases
- (7) Ensure environmental sustainability
- (8) Develop a global partnership for development

(See: www.un.org/millenniumgoals/)

Negative screening: An approach that excludes sectors or companies from a fund it involved in certain activities based on specific criteria, such as arms manufacture, publication of pornography, tobacco, animal testing, human rights, etc (Eurosif).

OECD Guidelines for Multinational Enterprises: are non-binding recommendations to enterprises, made by the thirty-seven governments that adhere to them. Their aim is to help Multinational Enterprises (MNEs) operate in harmony with government policies and with societal expectations.

(See: www.oecd.org)

OECD's Principles on Corporate Governance (1999/2004): Corporate governance, the OECD Principles and their implementation, both in member and non-member economies are the central areas of corporate affairs activities. The integrity of corporations, financial institutions and markets is particularly central to the health of their economies and their stability.

(See: www.oecd.org)

Pioneer screening: Positive screening where funds specialise in the best-performing companies against a specific criterion, such as management of natural resources (Eurosif).

Positive Screening: The selection, within a given investment universe, of stocks of companies that perform best against a defined set of sustainability or CG/SEE criteria (Eurosif).

Programme Related Investment (PRI) is a recoverable financial investment (not a grant) made with charitable intent to create charitable impact, where financial risk/return is intended to be concessionary. This might also be called Mission-Related Investing (MRI), the term used more often in Europe. MRI/PRI account for 1/10th of 1% of the US\$ 500 billion in total US-based foundation assets. PRIs count towards the 5% minimum payout required by US foundations.⁶⁹ (This is not a requirement in the UK, for example). When/if recaptured, it has to go back out in new PRIs or regular grants. They do not invoke fiduciary issues in the same way that the asset corpus does, and is not risk adjusted for financial return on investment.⁷⁰

69 US foundations that make international grants must make certain that the money is being used for charitable purposes and will count towards the minimum 5% requirement

70 Emerson, J. (2006). *Blended Value Investing: Capital Opportunities for Social and Environmental Impact*. pp.36-38. (See www.blendedvalue.org)

Loan/Credit Guarantees:

If a borrower may not have sufficient collateral, another party may pledge assets or general credit to meet the loan obligation if the borrower defaults. The party pledging the assets is the guarantor and often must place securities or other assets in an account that can be easily accessed by the lender in the event of a collateral call. This is called a loan guarantee or credit enhancement.

The versatility of the loan guarantee structure is well-known. "It can only be applied to a project that can be leveraged with debt; that is, the project must have relatively predictable cash flows. A loan guarantee might be used to launch a new project that may be somewhat speculative. The history of microfinance bond offerings and loan guarantees are profoundly intertwined (as noted in the section of this paper addressing innovations in debt finance), and loan guarantees were essential to the first issues as well as some of the most recently offered securities."

Loan guarantee arrangements are suitable in a variety of situations. Specifically, they can be useful to spur investment in new financial products, the likes of which mainstream commercial lenders have never seen. Another advantage of loan guarantees is that they can reduce exposure to currency fluctuations and, in the process, shift the exposure from the borrower to the guarantor. Under this arrangement, one only needs to convert one currency to another in the event of a default that results in a capital call."⁷¹

Reputational risk: Key aspects include: government's decisions to grant operating licenses; consumer decisions to buy products; Job-seekers' decisions to apply at a company; and impact of a CG/SEE event on share price.

Responsible Investment: is inherently a long-term approach to investing, sometimes at odds with the short-term vision prevalent on financial markets.

Socially Responsible Investing: is the broad term used to describe investments that reflect investors'

moral and ethical beliefs. SRI instruments are typically publicly traded funds that return to investors market-rate, risk-adjusted financial returns and are exemplified by socially responsible mutual funds such as Calvert, Domini, Pax World Fund, among others. Socially responsible investing usually incorporates screening of investment companies and shareholder activism through proxy voting. SRI investment strategies in the US represent more than US\$ 2 trillion or approximately one in eight dollars invested. The Social Investment Forum in the US recommends that all SRI Investors also engage in Community Investment – See World Economic Forum (2006). Blended Value Investing: Capital Opportunities for Social and Environmental Impact.

Sin Stocks: encompass investments in tobacco, alcohol, nuclear, military, gambling, pornography (Eurosif).

Triple bottom-line: An approach to investing based on People, Planet, and Profit performance indicators (also known as triple-P) (Eurosif).

UN Global Compact: strives to be the world's most inclusive voluntary initiative to promote responsible corporate citizenship, ensuring that business, in partnership with other societal actors, plays its essential part in achieving the United Nations' vision of a more sustainable and equitable global economy. Toward that end, the Global Compact will continue to pursue two complementary objectives: (1) Making the Compact and its principles on human rights, labour, environment and anti-corruption an integral part of business operations and activities everywhere; (2) Encouraging and facilitating dialogue and partnerships among key stakeholders in support of the ten principles and broader UN goals, such as the Millennium Development Goals.

Value-based investment approach: follows the same strict ethical guidelines they set in their programmes also for their investment mandates

Venture Philanthropy: 'a field of philanthropic activity where private equity/venture capital models are applied in the non-profit and charitable sectors' (European Venture Philanthropy Association).

⁷¹ Emerson, J. (2006). *Blended Value Investing: Capital Opportunities for Social and Environmental Impact*. pp.36-38. (See www.blendedvalue.org)

Voting: The exercise of voting rights for investors to influence company policy. Part of an engagement strategy but also a stand-alone activity (Eurosif).

FEATURED ORGANISATIONS AND RESOURCES

AccountAbility (Institute for Social & Ethical Accountability – UK)
www.accountability.org.uk

Bellagio Forum for Sustainable Development
www.bfsd.org

BITC Environment Index & Corporate Responsibility Index (UK)
www2.bitc.org.uk

BP
www.bp.com/home.do?categoryId=1

Business for Social Responsibility white papers
www.bsr.org

Calvert
www.calvertgroup.com

CalPers
www.calpers.ca.gov

Cazenove Capital Management
www.cazenovecapital.com

Cisco (Network Academies)
www.cisco.com/web/learning/netacad/index.html

CitiBank
www.citibank.com

CSR Europe (Newsletter)
www.csreurope.org

CSRwire.com Website
www.csrwire.com

The Ecumenical Council for Corporate Responsibility
www.eccr.org.uk

EIRIS
www.eiris.org

European Foundation Centre
www.efc.be

European Social Investment Forum
www.eurosif.org

European Venture Philanthropy Association (EVPA)
www.evpa.eu.com

Fonds de Réserve des Retraites in France (Retirement Reserve Fund, FRR).
www.fondsdereserve.fr

Generation Investment Management
www.generationim.com/

Generation Foundation
www.generationim.com/foundation/

GRI Sustainability Reporting Guidelines
www.globalreporting.org/guidelines/2002.asp

Henderson Global Investors
www.henderson.com

Hermes
www.hermes.co.uk

I.DE.A.M
www.ideam.fr

Innovest
www.innovestgroup.com

International Corporate Governance Network (ICGN)
www.icgn.org

Institutional Investor's Group on Climate Change (IIGCC)
www.iigcc.org

Institutional Shareholder Services (ISS)
www.issproxy.com

Interfaith Center on Corporate Responsibility (ICCR)
www.iccr.org

Joseph Rowntree Charitable Trust
www.jrct.org.uk

KLD
www.kld.com

MISTRA Foundation in Sweden
www.mistra.org
New Philanthropy Capital (UK)
www.philanthropycapital.org

NAPF
www.napf.co.uk

Novo Nordisk
www.novonordisk.com

PaxWorld Website
www.paxworld.com/invest.htm

RC Brown
www.rcbim.co.uk

SocialFunds.com
www.socialfunds.com

Social Investment Forum
www.socialinvest.org

SRI Compass/CSR Europe
www.sricompass.org

SRIstudies.org Website
www.sristudies.org/

StateStreet
www.statestreet.com

Sustainable Investment Research International Group
(SIRI)
www.siricompany.com

SustainAbility (UK)
www.sustainability.com

Trade Union Congress (TUC)
www.tuc.org.uk

T. Rowe Price
www.troweprice.com

UK Charities Statement of Recommended Practice
www.charity-commission.gov.uk/investigations/sorp/sorp05docs.asp

UK Social Investment Forum
www.uksif.org

UN Global Compact (Source Book)
www.unglobalcompact.org

World Economic Forum
www.weforum.org

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www.uksif.org/J/Z/Z/lib/2001/05/jp-hbook/jph-i-contents.shtml
- World Economic Forum (2006). *Blended Value Investing: Capital Opportunities for Social and Environmental Impact*. (See www.blendedvalue.org)

Appendix I

Calvert Social Investment Foundation

One of the first socially responsible mutual fund managers, Calvert Group offers individual investors a variety of screened socially responsible portfolios of public equities, bonds, and other money market products. In the late 1980s the company began to explore investment strategies that not only screened out social value destruction but sought actively to create social value with its investments. This discussion eventually led the fund to commit to investing 1% of its assets in community development finance intermediaries.

To facilitate this style of investing, Calvert Group eventually founded the Calvert Social Investment Foundation (Calvert Foundation) in 1995 with support of national foundations including Ford, MacArthur and Mott. The Calvert Foundation aims to affect community investment in the same way that Calvert Group built SRI: the foundation aims to refine the practice and productize investments so that individual investors can actively participate in community investing. In essence, the foundation has been charged with creating investment products that generate blended value. Overseeing this mission is Shari Berenbach, the president of Calvert Social Investment Foundation.

The Calvert Community Investment Note

Calvert Foundation's flagship investment product is called the Calvert Community Investment Note. Structured as general recourse obligation of the foundation, the Notes are designed to make it safe and convenient for average investors to direct capital to community development and other blended value-generating projects and enterprises. The Notes are highly customizable and can be purchased in increments of US\$ 1,000 (with a US\$ 1,000 minimum investment). Investors can choose the profile of the investments underlying their notes, targeting specific geographic regions and programmatic areas. Investors can also select the maturity of their Notes (ranging from one to ten years)

and the interest rate (from zero to 3 percent). Calvert Foundation will build completely customized community investment portfolios for investors deploying over US\$ 50,000 in capital.

In the ten years since the Notes' inception, Calvert Foundation has nearly US\$ 100 million in Community Investment Notes outstanding. This capital has been deployed across an US\$ 84 million portfolio of 195 borrowers, including American community development financial intermediaries, affordable housing developers, microfinance institutions, fair trade cooperatives and other domestic and international social enterprises.

The underlying portfolios are very carefully screened, monitored and managed. Calvert Foundation has put in place significant security enhancements that lower the Notes' risk such that the foundation has never defaulted on its obligations to any Community Investment Note-holders. The Notes currently have a 3% loss reserve and they are further collateralized by Calvert Foundation's balance sheet, which holds substantial assets that are junior to the Community Investment Notes. With the portfolios' average loan size at approximately US\$ 400,000, five average size loans would have to be complete losses to exhaust the loss reserves, and then realized losses would have to be substantially larger before they exhausted the cushion provided by the subordinated assets on Calvert Foundation's balance sheet. By late 2005, Calvert Foundation had over 2,400 Community Investment Note-holders. The largest note-holders are the Calvert Funds. 2,200 of those investors have invested less than US\$ 50,000, and 1,000 have invested US\$ 5,000 or less. Many of the 200 investors who have invested more than US\$ 50,000 are family foundations and high-net-worth individuals.

Building the community investment field

Calvert Foundation has helped to build the community investment marketplace by teaming up with partners to support their access to investors' capital. The first strategy used by the foundation has been to "private label" the Community Investment Note, thereby allowing organizations to wrap the investment instrument in their own brand, effectively piggybacking on

the existing Note registration and administration. Private label notes direct capital to specific loan portfolios or borrowing sectors. These notes stay on Calvert Foundation's balance sheet like all of its Community Investment Notes, and the private label products have the basically the same structure as Calvert's own Note product. Calvert prepares the prospectuses, manages the registration tasks, handles investor administration and collaborates with its partners to reach new investors and investees.

Sidebar or Table item: *Investment Notes established through Calvert Foundation's Private Label program—Source: www.calvertfoundation.org*

<i>Gulf Coast Recovery Initiative</i>	<i>Directs community investments to help those who were hardest hit by Hurricane Katrina and other recent devastating hurricanes.</i>
<i>Jubilee Investing Initiative</i>	<i>Directs faith-based community investments to non-profit lenders worldwide.</i>
<i>LGBT Community Investment Notes</i>	<i>Supports lenders that provide important community facilities and services for the lesbian/gay/bisexual/transgender community.</i>
<i>National Peace Corps Association Microenterprise Program</i>	<i>Invests in microcredit organizations, primarily FINCA, to offer working capital and financial services for the economically active poor around the world.</i>
<i>Oikocredit World Partnership Program</i>	<i>Oikocredit was founded 25 years ago as an alternative investment instrument for churches to provide credit for poor and disadvantaged people around the world.</i>
<i>Grameen Investments</i>	<i>Has directed capital to Grameen Foundation USA to help working poor in Bangladesh develop sustainable businesses.</i>
<i>MicroVest mPower Investment Program</i>	<i>Allows investment in microfinance institutions through the purchase of Community Investment Notes.</i>

Calvert Foundation limits the aggregate size of each these private label arrangements because its risk management regime precludes it from investing more than 5% of its portfolio into any one organization. Furthermore, the foundation works to meet internally defined capital adequacy guidelines in proportion to the liabilities created by the notes. These restrictions cap the amount of capital that can be invested in these customized products.

Establishing the Free Press Investment Notes

Calvert Foundation and MDLF had considered structuring the Free Press Notes within the Private Label program, but MDLF wanted to offer its own notes with an open-ended size. Accordingly, Calvert Foundation has supported MDLF through its Community Investment Partners program. The Community Investment Partners program makes Calvert Foundation's securities expertise available to other non-profits. For MDLF, Calvert Foundation prepared an "independent offering," performing the role of an investment advisor in structuring a security that is similar to a Community Investment Note offering that would affect MDLF's balance sheet, not Calvert Foundations. The two organizations launched the Free Press Notes in December 2005.

Following MDLF's Free Press Notes, Berenbach reports strong demand for other similar independent offerings, with several projects in the pipeline. With many products that have a standardized structure (the foundation's own Community Investment Notes, MDLF's Free Press Notes and the variety of private label notes), the foundation and its partners are fostering a uniform set of expectations for this manner of community investment product.

"Dematerializing" the Community Investment Notes

In its quest to make the Notes more ubiquitous and accessible to more investors, Calvert Foundation is actively establishing partnerships with financial institutions and securities brokerages. To make these relationships possible, the foundation has had to render the Notes compatible with the financial industry-standard electronic transaction systems – a significant challenge

that reveals a subtle but important obstacle that many blended value investment products will likely face as they become more accessible and productized.

Many financial firms transfer and clear investments through the Depository Trust Company (DTC), which maintains the electronic system through which most American securities transactions are processed. DTC's website explains, "The depository brings efficiency to the securities industry by retaining custody of some 2 million securities issues, effectively 'dematerializing' most of them so that they exist only as electronic files rather than as countless pieces of paper."⁷² DTC makes securities easily accessible to mainstream financial institutions that maintain their clients' portfolios in electronic format. Without being a part of the DTC system, Calvert Foundation's Community Investment Notes were not easily accessible through most investors' securities brokers. Compatibility with DTC would likely enlarge the market for the Community Investment Note products, and it could enlist a new sales channel when retail brokers are able to provide the product as an integrated portion of their clients' investment portfolios.

Unfortunately, gaining access to the DTC was no small task for Calvert Foundation, and Berenbach reports that it took nearly seven years to accomplish it. A key reason for the delay points directly at subtle but important differences between traditional retail investment (strictly for financial returns) and philanthropic investment (strictly for social or environmental returns). Efficient transactions of most liquid financial products are accomplished so that buyers and sellers remain anonymous to one another. The products must be completely fungible and DTC's 'dematerializing' promotes those characteristics.

That level of interchangeability and anonymity stands in contrast to the norms of philanthropy, wherein donors often customize their investments and remain in close contact with recipients (philanthropic donors often want anything but anonymity). The Community Investment Notes bring some of the practices of phi-

lanthropy to bear on blended value investing, giving investors extensive capacity to customize their investment products.

Because the DTC system has been built specifically to exchange fungible retail investment products, it was very difficult to make the Community Investment Notes, with their highly variable characteristics, interface with the DTC system. Fortunately, in late 2005 Calvert and DTC have established procedures for clearing the Community Investment Notes electronically. Clearing through DTC allows Calvert Foundation to establish relationships with new securities brokers, which Berenbach predicts will triple the size of its portfolio over the next five years.

The future of Calvert's Community Investment Notes

Currently, Calvert Foundation's Community Investments include a large range of underlying investment strategies including affordable housing finance, microfinance, community facility funds, small-business loans, fair trade investments and investments in social enterprises. Looking to the future, Berenbach anticipates that in the next several years, the foundation will be investing in environmental projects, the health sector and off-grid power and telecommunication investments.

⁷² Depository Trust Company. "About DTC." <https://login.dtcc.com/dtcorg/home/page18832.html>. December 2005.

Appendix II

Completed Surveys and Interview Participants

Charles Stewart Mott Foundation (US)
Compagnia Torino (Italy)
Cultural Bank of Cyprus (Cyprus)
Esmée Fairbairn (UK)
Evrika (Bulgaria)
FLAD (Portugal)
Foundation for Polish-German Cooperation (Germany)
Foundation Het R.C. Maagdenhuis (Netherlands)
Fondazione di Venezia (Italy)
Fundação Oriente (Portugal)
Finnish Cultural Foundation (Finland)
Fondazione cassa di risparmio di Roma (Italy)
Ford Foundation (US)
Gerda Henkel Stiftung (Germany)
Jerusalem Foundation (Israel)
Joseph Rowntree Charitable Trust (UK)
King Baudouin Foundation (Belgium)
King Gustaf V 90th Anniversary Foundation (Sweden)
MISTRA (Sweden)
Rabobank Foundation (Netherlands)
Robert Bosch Foundation (Germany)
Schweissfurth Stiftung (Germany)
Svenska Kulturfonden (Finland)
Van Leer Group Foundation (Netherlands)
Vladimir Potanin Charity Fund (Russia)

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