SEAL COVE FINANCIAL

Impact Investing for Small, Place-Based Fiduciaries:

A Summary of the Research Study Initiated by the

United Way of the Bay Area

Impact Investing is an investment strategy that intentionally aligns the investments of an organization with its mission, seeking to achieve both a prudent financial return *and* a positive impact on the mission.

As a fiduciary for non-profit and public funds for many years, and as an investment professional, I became intrigued with the question of how one could adopt an investment strategy that could align with an organization's mission while adhering to traditional fiduciary standards. In my case, the United Way of the Bay Area offered an opportunity to research and develop a potential investment process and possible structure for its endowment fund that would align with its mission to reduce poverty in the Bay Area.

Most fiduciaries of institutional funds (public defined benefit plans, endowment funds and quasi-private/public foundations) have been reluctant to adopt Impact Investing, Socially Responsible Investing (SRI) or Environmental, Social and Governance (ESG) factors in their investment policies and philosophies, for many reasons. Primarily, such social impact factors are deemed to be limiting to the opportunity set of investments and therefore imply a financial return that is potentially sub-standard. As fiduciary duty interpretations have evolved over the years, current practices seem to dictate a sole focus on achieving a maximum rate of (risk-adjusted) return without any regard to the social or environmental externalities in the world today. Resource scarcity, such as energy or water, or other limits to growth, and the consequences of climate change, are risks in our future that are not incorporated into standard Modern Portfolio Theory and Capital Asset Pricing Models, which base risk model factors (correlations) on historical asset class relationships. One can argue that ESG factors ought to be critical to the investment processes and policies of fiduciaries of long-term, intergenerational asset pools.

Nonetheless, current practices of fiduciary standards today would consider creating portfolios that would incorporate ESG factors or positive social impact intentions in addition to prudent financial returns *only* if they can be shown to be 'economically indistinguishable' from traditional investment opportunities as measured against standard (backward-looking) benchmarks. Therefore, we will apply this more narrow interpretation and consider only investments that do not suggest a sacrifice in expected returns.

We were challenged to identify if and how a model portfolio could be built for a small, place-based endowment fund, like that of the United Way of the Bay Area (UWBA) and whether our stock and bond investments could be aligned with our mission to reduce poverty in the San Francisco Bay Area, without deviating from our fiduciary responsibilities. The Ad Hoc Committee, consisting of some senior staff and members of the board and investment committee, undertook the challenge to create a process that (1) would identify appropriate investments, (2) design a model portfolio, (3) test that portfolio against current financial theory, traditional metrics of risk and return expectations and traditional diversification standards, (4) seek alignment with the long term goals and objectives of the organization, and (5) meet our fiduciary duty as defined by UPMIFA (Uniform Prudent Management of Institutional Funds Act) and Prudent Investing standards.

Impact Investing

Impact Investors can be classified into three main categories: Impact First (primarily seeking to maximize impact while secondarily expecting financial returns, if any, i.e., the grant); Investment First (fiduciaries primarily seeking market-rate or premium returns and secondarily (if at all) seeking a positive social or environmental impact); and Catalyst First (seeking to give or invest to collaborate to build the Impact Investing industry and infrastructure).

Traditionally, Socially Responsible Investing (SRI) strategies were based on actively excluding companies whose products or activities were contrary to an organization's mission or beliefs. These SRI strategies are primarily limited to the public equity portion of portfolios. SRI has produced a fairly large number of choices of investing options and strategies in its screens or focus (for example, faith based issues or green funds), and account for over 10% of global institutional equity assets.

Impact Investing is a more proactive, intentional strategy seeking to find investments that offer both a strong financial return as well as a positive social and/or environmental impact. Impact investing strategies can be implemented across all asset classes in a variety of investment vehicles, with varying degrees of liquidity, performance expectations, risk, and impact. Equity investors that seek impact can apply Environmental, Social and Governance (ESG) factors and screens and research corporate sustainability reports (CSR) in their analysis to build portfolios of companies that are aligned with a particular mission or goal. Equity investors can also impact corporate behavior through shareholder activism and proxy voting. Fixed income investors can identify impact more directly than equity investors, particularly through the community development and affordable housing bond markets, which are some of the earliest, largest and most successful examples of impact investing. Long term investments in infrastructure would have alignment and impact with many missions for healthy and diverse communities and economic development. Real Estate and Private Equity /Venture Capital can have some of the greatest impact through direct private equity and private debt, but often with less liquidity and transparency. Global impact investment opportunities in all asset classes can have a huge impact on the "Bottom-of-the-Pyramid", the poorest and most vulnerable in our world, while also delivering strong financial returns, as shown by micro-finance/micro-lending. Regionally-based impact investments for place-based missions can also be effective as well as prudent and provide an opportunity to track impact locally. Taking a whole portfolio approach, as directed by UPMIFA and prudent investor standards, organizations and fiduciaries of institutional assets can build impact into any or all parts of a portfolio with the appropriate intention, due diligence and oversight.

For our research, we determined that there are several characteristics to achieve to assure our fiduciary standards were upheld: (1) have low fees, (2) use a rules-based and objective process, (3) be implemented through professional (conflict-free) registered investment advisors, (4) be monitored through a prudent, standard due diligence process based on traditional benchmarks, and (5) expect market-like returns. By following a step-by-step process, beginning with a clear definition of the goals and mission of the UWBA, we identified a number of investment themes that would be aligned with a poverty alleviation mission.

Impact Investing Process*	**UWBA Research Process**
Articulate Mission and Values	UWBA goal: Reduce Poverty in the Bay Area by ½ by 2020
Impact Themes	Community Development, Affordable Housing, Job Training, Employment
Define Impact	Quantify jobs and growth, unemployment rates decline, affordable housing units built, transportation funding, etc.
Develop Impact Investing Policy	Develop Investment Policy: asset allocation, liquidity requirements, risk budgeting, spending, monitoring, etc.
Generate Deal Flow	Gather universe of ESG/Impact investment managers in all asset classes, model portfolios
Analyze Deals and Evaluate Impact	Perform due diligence, monitor financial results and social impact, test for comparable performance and risks

Source: Solutions for Impact Investors: From Strategy to Implementation, Rockefeller Philanthropy Advisors

We were able to draw on UWBA staff, research and its roadmap as it achieves its goals to reduce poverty. That helped us identify the social drivers that help to alleviate poverty, like job creation and affordable housing. Corresponding objective criteria were identified that could act as proxies for reducing poverty. We also were limited to the liquid public markets in stocks and bonds because the endowment fund at UWBA is relatively small. The United Way 'brand' is typically funded through workplace giving by corporate and philanthropic partners and passed through as grants and support, instead of through raising and maintaining a large endowment fund.

While there are now new databases and investment vehicles in many flavors of environmental and social criteria and constraints, there were no existing "off-the-shelf" ESG –type equity mutual funds that focused on poverty alleviation with a geographic spotlight on the San Francisco Bay Area. Fortunately, there are many creative and brilliant financial and academic experts in the Bay Area who helped us find our solution. Because job creation and employment reduce poverty, we sought to identify companies in the Bay Area that were 'good' employers, believing that a good job with a good company that offered good salaries and benefits, had good labor relations, and transparent and diverse management and governance structures contributed to poverty reduction through steady employment.

This resulted in our plan to create a 'Bay Area Employers' index of companies headquartered in the San Francisco Bay Area, including large employers who generally support the mission of UWBA. We found that there already exists a Bloomberg Bay Area Index of nearly 400 companies headquartered in the Bay Area, developed by the San Francisco Chronicle and Bloomberg in 2003 (symbol: BBACAX). It is a cap-weighted index, with its top 5 companies representing 50% of the universe: Apple, Chevron, Google, Oracle, and Wells Fargo. The following table shows how much tracking error the cap weighted index had to the S&P 500, so the committee opted to use the index as the underlying universe and optimize that universe against our benchmark rather than to cap-weight or equal-weight in order to minimize tracking error.

Model Portfolios Structure	Tracking Error to S&P500 BBACAX + 15	Tracking Error to S&P 500 BBACAX
Cap Weighted	**5.39%**	**6.17%**
Equal Weighted	**15.68%**	**15.81%**
Optimized	**2.68%**	**2.82%**

Model Sector Allocations

GICS Sector	Optimized BBACAX – HQ	S&P 500
Consumer Discretionary	10.14%	10.60%
Consumer Staples	7.20%	10.50%
Energy	13.18%	13.10%
Financials	16.36%	14.75%
Health Care	13.50%	11.42%
Industrials	5.48%	10.95%
Information Technology	27.09%	18.72%
Materials	0.55%	3.65%
Telecom Services	0.00%	2.93%
Utilities	6.52%	3.37%
Wtd Avg Mkt Cap	$ 84 billion	$ 94 billion

Except for Telecommunications Services, all major industries are represented in the Bay Area. We are overweighted in Information Technology, Financials and Health Care and underweighted in Industrials and Materials. Our surprisingly diverse and remarkably robust region is the 19th largest economy in the world, and is home to the second largest concentration of Fortune 500 companies in the world. We recognized however, that there are some sectors and companies that should be better represented in our universe to reduce tracking error and more closely represent some of the largest employers in the Bay Area. Bank of America is no longer headquartered here, nor is Pac Bell, (now ATT) but both, as well as a dozen others companies, are significant local employers and supporters of UWBA. Including those extra companies helped create a universe of companies from which we could build a unique portfolio aligned with our social mission and geographic focus, which we call BBACAX + 15.

We determined a series of social criteria that would be proxies for identifying companies that could be classified as being ‘good employers’ (S), having ‘good management’ (G) and behaving as ‘good environmental stewards’ (E) in the Bay Area. We ranked those criteria and used objective data sources to identify companies who rated well in these ESG criteria to create a custom score for each company in the universe. Identifying only the top handful of criteria that are relevant to a poverty alleviation mission meant that we did not dilute the screening intentions with too many factors.

Customized Social Screens

- 25 Categories – Focus Group consensus recommendations
- Alignment with drivers of poverty reduction

Highly Relevant to Poverty	**Moderately Relevant**	**Low Relevance**	**Not Relevant**
Job Creation	**Human and Employee Rights**	**Gambling**	**Tobacco** **Alcohol**
Labor Relations	**Workforce Diversity, including Sexual Orientation**		**Adult Entertainment** **Animal Testing**
Recognition (Corporate)			**Bioethics**
	Environmental		**Firearms** **Life/Choice**
	Corporate Governance Metrics **Auditing Practices** **Board Accountability** **Board Composition** **Board Independence** **CEO Compensation** **Company Ownership** **Shareholder Rights** **Takeover Defenses**		**Military** **Nuclear Power**

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Developing weights for those factors, through a consensus voting process by the committee and staff, we created a custom scoring system unique to our mission. Each company/stock in the universe would be evaluated on its custom ESG score as well as for its fit in the portfolio structure as measured by its contribution to diversification and minimizing tracking error.

Social & Geographic Criteria

- Focus Group consensus sample criteria recommendations
- **Weightings**: High is 2x Medium, Medium is 2x Low
- **Exclusions:** Gambling (use 20% threshold)
- **Positive Scoring:** based on objective data
  - Job Creation (High): defined by Universe of Bay Area employers

Criteria	Data Elements	Importance	Weighting	% of Total
Labor Relations	Evaluation of Relationships with Organized Labor	High	4	22%
Recognition	Workplace and Diversity	High	4	22%
Diversity	Total Workforce and Management	Medium	2	11%
Sexual Orientation	Non-discrimination Statement Same Sex Benefits	Medium	2	11%
Environmental	Toxic Release Information and Spills	Medium	2	11%
Human Rights	Global Sullivan and Global Compact	Medium	2	11%
Corporate Governance	Governance Metrics Grades.	Medium	2	11%

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Using computer-driven portfolio optimization programs at the Aperio Group of Sausalito, CA (an investment firm that builds custom portfolios) we developed a series of portfolios with varying levels of custom ESG scores and tracking error to the Russell 3000. The goal was to create a model portfolio of stocks that would maximize the aggregate custom ESG score while minimizing the tracking error to the

Russell 3000, thereby balancing idealism with pragmatism. We also tested three different underlying universes of stocks, since we could see that the tracking error resulting from the geographic focus was much greater than the tracking error resulting from the ESG screens. The three universes varied by the degree to which the companies in the universe were headquartered in the Bay Area or not: 100%, 75% or 50%.

Sample Portfolios

	Bay Area 19%	Bay Area Only -100%		Bay Area Co's 75% of portfolio			Bay Area 50% of portfolio	
Screened Portfolio Version	**R3000 Index**	**1**	**4**	**8**	**10**	**13**	**7**	**11**
Benchmark	R3000	R3000	R3000	R3000	R3000	R3000	R3000	R3000
Model Universes	R3000 Index	**BBACAX+15**	**BBACAX+15**	**BBACAX+15 +25% other**	**BBACAX+15 + 25% other**	**BBACAX+15 +25% other**	**BBACAX+15 +50% other**	**BBACAX+15 +50% other**
Universe - Holdings	2,940	252	252	1,982	1,982	1,982	1,982	1,982
Standard Deviation	20.43	20.57	20.65	20.48	20.52	20.49	20.44	20.47
Tracking Error vs. Benchmark, %	**0.00**	**2.41**	**3.02**	**1.36**	**1.95**	**1.64**	**0.67**	**1.32**
Model UWBA Social Score	*46*	*51*	*65*	*50*	*65*	*60*	*49*	*65*
Bay Area Weight%	***19***	***100***	***100***	***75***	***75***	***75***	***50***	***50***
Number of Holdings	2940	126	99	264	178	210	450	294
Average Market Capitalization, $Billions	87.9	80.0	93.2	89.0	89.0	89.5	89.8	91.6

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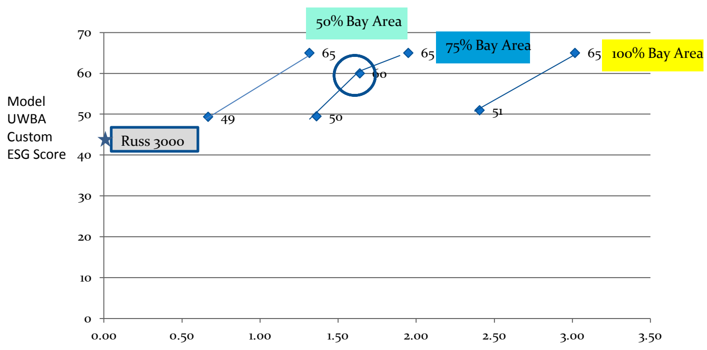
Graphing the various portfolios that demonstrated the trade-off between tracking error and high-to-low ESG scores, over the three universes, resulted in three ‘frontiers’. The resulting “middle” equity portfolio (#13 in the chart above) seems to balance the desire for a highly rated ESG portfolio with the desire to minimize tracking error to the benchmark. In this portfolio, the equity holdings, of which 75% are headquartered in the Bay Area, compares well with the Russell 3000, where 19% of the companies are headquartered in the Bay Area. This model portfolio is tilted towards the companies whose practices were aligned with positive employee relationships, good governance and good environmental practices. Being optimized against our benchmark, the portfolio is expected to exhibit sector weightings, risk and performance expectations similar to the Russell 3000, with a tracking error of 1.64%. The screens used in the custom ESG scoring system improved from the basic ESG score for the Russell 3000 of 46 to the model portfolio’s ESG score of 60, a 30% improvement for ESG criteria at a small (less than 2%) cost to tracking the benchmark.

Choosing the parameters for the Model

- Custom ESG Scores, Tracking Error, Geographic Focus



UWBA Model Portfolio: "Impact Bay Area"

– Benchmarks: R3000, Barclays Aggregate

Model Equity Universe	BBACAX+15+ 25% other	Russell 3000 Index
Universe – Holdings	1,982	2,940
Standard Deviation	20.49	20.43
Tracking Error vs. Benchmark, %	**1.64**	**0.00**
Model UWBA Social Score	*60*	*46*
Bay Area Weight%	***75***	***19***
Number of Holdings	210	2940
Average Market Capitalization, $Billions	89.5	87.9

– Fixed Income: Bay Area affordable housing, GNMA and FNMA, corporate and taxable muni bonds

This model portfolio is now more aligned with the core mission of UWBA and can be expected to earn market levels of return and experience similar risks as its benchmarks. The historical performance of the model equity portfolio was within range of the projected tracking error, with the model portfolio outperforming its Russell 3000 benchmark for the two year period ending December 31, 2012 10.83 % versus 8.42% annualized.

The UWBA fixed income strategy was easier to develop and implement. We found an existing fund that was aligned with community development and reinvestment goals nationally. Community Capital Management has a large institutional CRA (Community Reinvestment Act qualified) fund (symbol: CRANX) that could earmark for UWBA a variety of San Francisco Bay Area regional bonds, such as Affordable Housing and Redevelopment Agency bonds, local specific GNMA and FNMA single and multi-family mortgages, some special community development (Small Business Administration), and corporate / regional Salvation Army bonds. Our performance would be that of the entire fund, benchmarked against and tracking the Barclays Aggregate bond index, which addresses our fiduciary duty and meets our goal to align with the mission. With the earmarking process, UWBA would be able to track its local impact footprint.

The San Francisco Bay Area will need to continue to invest in itself to stay competitive and deliver cutting-edge thought, product and service innovation. Identifying how fiduciaries can invest locally, in stocks, bonds, infrastructure, real estate and private markets regionally, can provide a new source of funds for investment in Bay Area competitiveness into the future.

While we recognize that a small portfolio of stocks and bonds would have a limited, indirect impact on poverty at best, we hope that the potential public *conversation* about building a prudent portfolio under current fiduciary standards that is aligned with a specific place-based mission could have a much larger impact on influencing the flow of funds into needed public/private, regional, community-based investment opportunities and perhaps also help to act as a model for other regions. We urge continued collaboration between the participants in all sectors to explore how to use fiduciary capital, in all asset classes (equity, fixed income, infrastructure, real estate and private capital) to transform our economy, to invest in our region, state and infrastructure, and to create a future that will continue to foster prosperity, innovation and shared economic growth in the San Francisco Bay Area for generations to come.

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For a complete list of references, definitions, links, sources, and acknowledgements, please see the full report posted on the website of the Federal Reserve Bank of San Francisco:

http://www.frbsf.org/publications/community/wpapers/2012/wp2012-05.pdf

Please note: The United Way of the Bay Area was the initial seed ground of this study. It has not endorsed and does not support any particular investment strategy at this time.