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Impact Investing:
Environmental, Social & Governance criteria promote sustainable, positive outcomes.

By Lauryn Agnew October, 2010

The old Socially Responsible Investing (SRI) strategy has evolved to be more proactive and rewarding, incorporating broad concepts like sustainability and governance across all asset classes.

New investment strategies are appearing to meet the growing demand by more investors for financial instruments that offer a competitive financial return AND positive outcomes in social, environmental and corporate governance issues. Originally, Socially Responsible Investing (SRI) applied only to the public equity sector and was about negative screens: avoiding companies that behaved poorly (apartheid) or made 'bad things' (like tobacco products, bombs, alcohol, etc.) Such screens were believed to limit the available universe to the 'good' companies by restricting the potential investable universe to a smaller set, resulting in higher tracking error against benchmarks, and potentially lower returns. Recent studies* of 18 years of SRI index performance indicate neither a negative nor positive alpha from SRI screens: the long term returns are competitive.

Fortunately, simple negative screening has evolved to be much more proactive in the past couple of decades. These newer Environmental, Social and Governance (ESG) strategies available to investors are spread across all asset classes with a variety of structures and targeted impact. Now it can be easier for asset owners (pension plans, foundations, private portfolios) to align the objectives of their investments with their own values and missions, addressing such issues as mitigating climate change, improving water quality or alleviating poverty conditions.

Impact Investing, is a very broad term that encompasses the concept that investors can get competitive financial returns AND make a positive social impact with their capital. Fiduciaries must seek market rate returns (and not sacrifice the expected return for a positive impact), nor should they consider investments which would be contrary to the current due diligence, asset allocation and investment policies in place. There are many large asset pools, both private and public, that are successfully integrating their risk and return expectations with the goal of channeling some of their capital towards investments with a particular intended (though non-financially quantifiable) impact.

Picture Impact Investing as being a continuum of investment opportunities. Traditional investing would be at one end of the spectrum, offering a market return/no impact while the opposite end of the continuum would be the grant: no financial return, all impact. Within each asset class, and with different combinations of returns, risks, and liquidity, impact investments can be viewed along the continuum of potential return. Market return vehicles, like equity, fixed income and alternatives (private equity, hedge funds, etc.) would share space on one side of the scale, while below-market rates of return investments like Program Related Investments (PRI) and Grants share the other side. Some investors, like fiduciaries of retirement assets, will be looking only at the market return side while private foundations may be able to consider below market return opportunities like PRI and supporting grantees in unique ways with additional capital. Public/Private partnerships could provide for a range of financial returns to the participants who combine their resources for a common positive impact.

Still in its early stages, the Impact Investing community is addressing the issues of public awareness, impact measurement, policy development, product development and collaboration between investors and the creators of investment strategies. Each major asset class brings unique structures and potential impacts, so that some level of Impact Investing could be applied across all parts of the portfolio and all categories of targeted impact: e.g., sustainable communities, environmental (clean energy, climate change, water), and social (education, children's health, etc) issues.

Public Equity Portfolios

Equities markets give us a clear way to 'vote our dollars'. The Public Equity space is often the largest asset class in our institutional portfolios. It provides investors with liquidity, growth (inflation protection) and transparency in pricing. Equities may be less efficient at being measured for direct impact, but because we as shareholders get to VOTE our proxies, shareholder activism can be a powerful force for change in corporate behavior. Many large shareholders, such as CalPERS, are active in the public equity sector through shareholder activism: voting proxies, submitting resolutions, and working with management for long term positive change.

Other impactful public equity strategies have evolved to include proactive, sustainable investing strategies and encompass more social, environmental and governance issues. For example, funds can own companies that are developing products, technologies and services with positive environmental impact. Fortunately, more recent academic studies are finding linkages between corporate ESG programs and good stock performance: good corporate ESG management and good risk mitigation can be indicative of a company's ability to respond to long term trends and maintain a competitive advantage**. Consequently, we can look at this kind of additional criteria, like potential impact, in choosing investments without sacrificing our fiduciary responsibility to get good returns.

Investment strategies and mutual funds are now offered in many flavors of ESG or Sustainability. It requires a bit of corporate soul-searching to identify the broad mission and values of the organization as well as a process for implementing those values with investment vehicles. Appropriate due diligence is needed to align the values and mission of an organization with the investment objectives of the chosen funds and strategies. Websites and databases collect information on investment vehicles in each asset class that offer a combination of financial return and social impact.

Fixed Income Investments

Fixed Income is usually a big portion of our portfolios. In the past there were not many opportunities to use our fixed income assets to make a social impact. Now there are more and more bonds that can give us the attractive aspects of owning fixed income securities, like the promised coupon (yield), within a specific time frame (maturity), and within an understandable, quantifiable risk level (default risk) AND with the added benefit of some positive impact. Some of these Impact-oriented fixed income investments provide liquidity directly to certain projects, like affordable housing, micro-investing/micro-lending, or global green bonds. We might be able to get better metrics from our fixed income investments about Impact (# of houses or clean water systems built) than we can in the public equity space.

Knowing the terms of the Impact bond portfolios will make it easier to know where these investments can fit in our asset allocation (short or long duration, domestic or global, investment grade or high yield). These assets can continue to act as a diversifier and lower the risk of the entire portfolio because they have low correlation to and less volatility than equities. Understanding these attributes within our whole portfolio context is part of the necessary due diligence process. When we monitor the portfolio and performance against its benchmarks over time, we can track the Impact as well.

Alternative Investments

Sustainable/Impact/ESG investment strategies can be found in private equity funds, loan funds, hedge funds, venture capital, and other funds of funds vehicles. In the Alternative space in our portfolios, we can often see the direct beneficiary of the capital investment: R&D for vaccines, green and clean tech development like solar, electric cars, etc., community outreach programs and providers. Collaboration between private and public investors may also yield different investment structures with different risk characteristics that achieve common goals, like a public/private partnership for affordable housing, economic development and open space development.

Impact Measurement and Geographical Focus

Different investing organizations (asset owners) will be challenged to define their desired outcomes when they try to align their missions with the investment objectives of a particular investment strategy. Standards are developing for comparison and measurement of impacts that investors can use in their due diligence. Additionally, the geographical focus of both the investor and the investment strategy can be a largest factor in identifying the right fit between investor and investment. Some organizations and some investment strategies are more global in nature, while others are specific to a certain geographical region.

Summary

Also sometimes called Double or Triple Bottom Line Investing, Impact investing, in its many forms, is being embraced by leading private and public investors. The current demand for such strategies is estimated at $120 billion, but that still represents only a very small percentage of the approximately $30 trillion in total global financial assets. As demand for such investment vehicles grows, so will the inventory of such opportunities grow across all asset classes. Collaboration between investors and product providers can help funnel global capital to new and sustainable business practices that can lead to long term solutions to serious issues at the community, national or global level. Re-directing even some of the liquidity of traditional investment portfolios into sustainable companies, innovative products and services, or creative solutions to existing social problems could have a significant impact on the speed of improvement in these areas. Following normal existing due diligence and investment practices and policies, fiduciaries can implement impact investing opportunities into their portfolios without sacrificing return expectations or diversification benefits.

LaurynAgnew@SealCoveFinancial.com ***www.sealcovefinancial.com***

Sources of information: The following links are not endorsements; they are provided for information purposes only.

*SRI return study: Lloyd Kurtz and Dan Dibartolomeo "The Long Term Returns of a Social Investment Universe, Working Paper 2010" CFA Society of San Francisco, 10/14/2010

United Nations Environmental Program: UN Principles for Responsible Investment:

> "The Principles for Responsible Investment (PRI) is a best-practice framework designed to assist members of the investment community in incorporating environmental, social and governance (ESG) issues into investment decision-making and ownership practices."

**Equity returns studies: United Nations Environmental Programme Finance Initiative Asset Management Working Group:

www.unep.org/documents.multilingual/default.asp?DocumentID=399&ArticleID=4539&l=en

Globalization and the Environment: Mobilizing Finance to meet the Climate Challenge Presented by the UNEP Finance Initiative: http://www.rona.unep.org/documents/partnerships/2007/2007-4.LisaPetrovicPresentation.pdf

California Public Employees' Retirement System: CalPERS

> "We believe good corporate governance leads to better performance. We seek corporate reform to protect our investments." http://www.calpers-governance.org/
>
> Environmental Investment Initiatives:
> http://www.calpers.ca.gov/index.jsp?bc=/investments/environ-invest/home.xml

Corporate Sustainability: Mission Statement of APG (largest pension manager in the Netherlands with ~240 billion Euros)

> "Asset management plays an important role in corporate social responsibility. We are of the opinion that consideration for people and the environment can go hand in hand with a good financial performance. In the coming years, APG will be paying a lot of attention to investment projects that have a sustainable character, such as alternative energy, environmentally friendly technology and infrastructure. Moreover, we actively see to it that this approach is given as broad support as possible."
>
> http://www.apg.nl/apgsite/pages/english/about-apg/organisation/corporate-social-responsibility/

Pubic Equity strategies

- Impax Specialists Strategy www.impax.co.uk
- Terra Verde Capital Management www.terraverdecap.com – Fund of Hedge funds/Environmental
- Baldwin Brothers' Highwater Global Fund www.baldwinbrothersinc.com
- Boston Common Asset Management www.bostoncommonasset.com

Fixed Income Strategies:

> **World Bank Green Bonds:**
> http://treasury.worldbank.org/cmd/htm/WorldBankGreenBonds.html
> Nikko Asset Management www.nikkoam.com/english

Affordable Housing, Transit Community Development

- Community Capital Management www.ccmfixedincome.com
- Enterprise www.enterprisecommunity.org

- Rose Smart Growth Investment Fund I, LP ticker: RSGF www.rosecompanies.com

Green Real Estate:

Gerdin Edlen Green Cities, I LP www.gerdingedlen.com

Private Equity – Environmental

EKO Green Carbon Fund, LP www.ekoamp.com

Social Investor Networks:

- GIIN: Global Impact Investing Network
- www.Toniic.om
- www.capitalmisstions.com
- Investors' Circle (angels)

Research Material: Rockefeller Philanthropy Advisors white papers on Impact Investing