

Impact Investing for Trusts

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Why Should You Care?

- **Client creating a trust**
- **Beneficiaries of a trust created years ago**
- **Trust for beneficiaries of multiple generations**
- **Charity with an endowment**

The Questions

- **What do the terms mean?**
- **What are different types of investment strategies?**
- **What is the financial effect?**
- **Can a fiduciary use these strategies?**
- **What about planning, drafting?**

Terms

- **Socially responsible investing**
- **Impact investing**
- **Values-based investing**
- **Mission-related investing**
- **Program-related investing**
- **ESG investing**

Socially Responsible Investing

- **Negative Screens**
 - **Apartheid**
 - **Sin Stocks**
 - **Divestment**
- **Positive screens - best in class**
- **Shareholder advocacy (proxy voting)**

Impact Investing

- **Impact first or finance first**
- **May mean lower returns – more impact if returns lower**
- **Fiduciary analysis depends on type of impact investing**

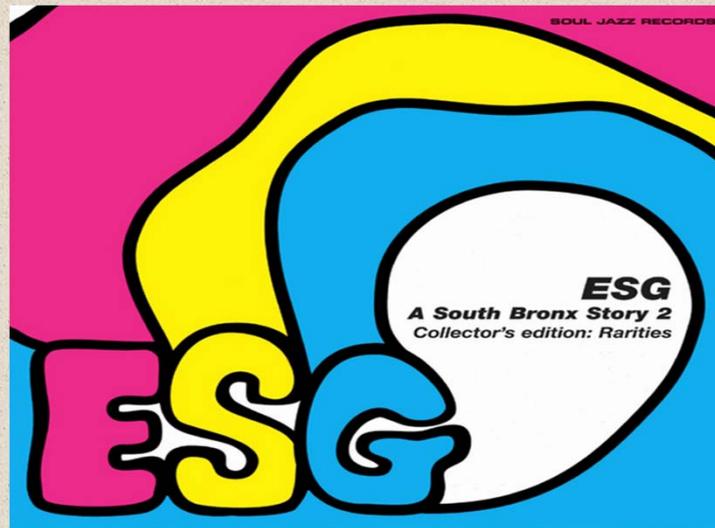
What is ESG Investing?

- **E**nvironmental
- **S**ocial
- **G**overnance

Extra Street Gangsta



Emerald, Sapphire, Gold



Environmental, Social and Governance Investing

Goals:

- Improve financial performance by expanding information considered
- Invest in a sustainable and responsible manner

ESG Investing

- **Traditional financial analysis**
- **Material ESG factors that have financial implications or effects**
- **Sustainability reporting and integrated reporting**

Deep Horizon Explosion



ESG Investing – Example

- **BP had troubling environmental and safety controls and prior incidents**
- **2010 Deepwater Horizon oil spill had serious financial consequences for BP**
- **A decision to remove BP from a portfolio based on earlier safety and environmental problems would have had financial benefits for investors**

Example – Social Factors

- **Company A – lower costs to produce goods using sweat shop labor**
- **Company B – higher costs due to better labor conditions but lower risk of break in supply chain, loss of goodwill, boycott**

ESG Integration

- **ESG factors may be source of liability and value destruction**
- **Possible opportunities**
- **Possible outperformance with information not everyone uses**

There Must Be a Cost

- **Modern Portfolio Theory emphasizes diversification**
- **Any restriction on diversification results in a cost to the portfolio**
- **SRI = negative screens = restriction on diversification**

But ...

- **Efficient market theory faces challenges - market does not reflect all information**
- **SRI has changed and no longer relies on negative screens**
- **Studies show no necessary cost**

Data

- **Studies show SRI strategies will have positive or neutral effects when compared with non-SRI**
- **Studies show ESG investing more likely to have positive effects**
- **Results may depend on manager, market conditions, timing**

Growing # of Funds – Social Investment Forum

- **From apartheid to best-in-class**
- **ESG integration**
- **Exclusions are based on ESG**
- **Numbers growing: \$12 billion in 1995 to \$4,306 billion in 2014**

Financial Analysts

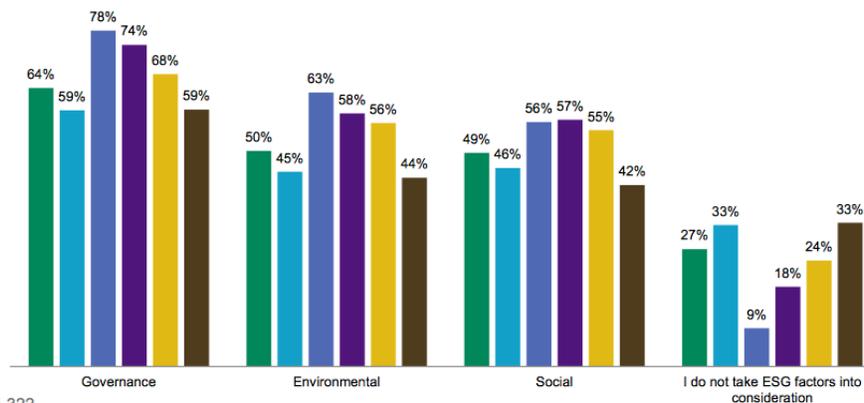
- **Metrics in Bloomberg database**
- **Less risk in more transparent companies**
- **Companies with high CSR ratings ranked higher**

CFA Institute 2015 Survey

- CFA Institute members that are portfolio managers and research analysts were invited to participate in an online survey. 1,325 valid responses were received, for a response rate of 3% and a margin of error of $\pm 2.7\%$.
- 55% of respondents were from USA; 11% from Canada

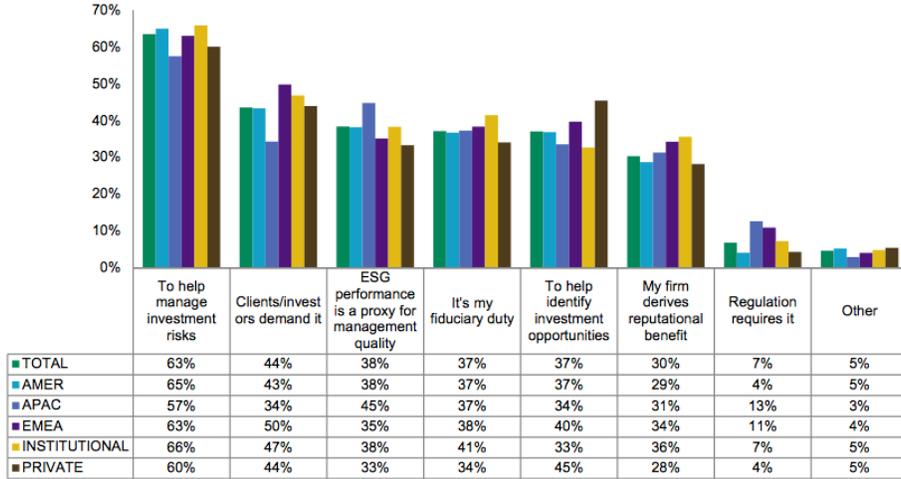
Which, if any, of the following ESG issues do you take into account in your investment analysis or decisions?

■ TOTAL ■ AMER ■ APAC ■ EMEA ■ INSTITUTIONAL ■ PRIVATE

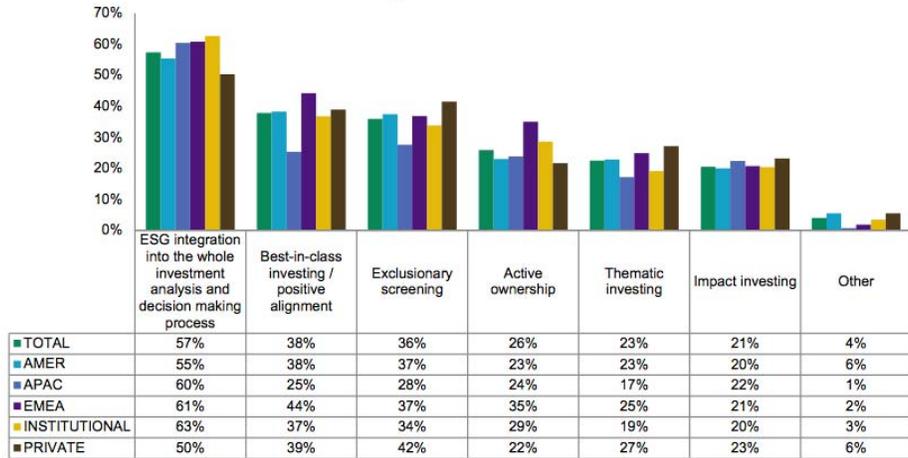


N=1,322

Why do you take ESG issues into consideration in your investment analysis/decisions?



How do you take ESG issues into consideration in your investment analysis/decisions?



946

Sustainability Reporting

- **Global Reporting Initiative (GRI) Standards**
- **Global International Integrated Reporting Council (IIRC) - International Integrated Reporting Framework**

Sustainability Accounting Standards Board - SASB

- **Standards are industry-specific, create performance metrics and create a process for determining materiality**
- **Issued for 79 industries grouped into 11 sectors**

Reporting by Companies

- **Increasing numbers of companies report on sustainability**
- **SEC requires companies to report on material information**
- **ESG issues should be subject to the same materiality standards as other sources of risk and return**

Fiduciary Duties

- **Duty of Loyalty**
- **Duty of Care or Prudence**
- **Duty to Act as a Prudent Investor**
- **Duty of Impartiality**

History of Prudent Investor

- **Legal lists**
- **Harvard v. Amory (1830) - prudent man standard but interpretations focused on principal and avoidance of risk**
- **Uniform Prudent Investor Act**

UPIA and UPMIFA

Manage the property as a prudent investor would:

- **Purposes, terms and distribution requirements**
- **General economic conditions**
- **Modern portfolio theory – manage risk across the portfolio**
- **Appropriate risk and return**
- **Diversification**

Restatement

The rules must be general and flexible enough to adapt to changes in the financial world and to permit sophisticated, prudent use of any investments and courses of action that are suitable to the purposes and circumstances of the diverse trusts to which the rules will inevitably apply.

Things Have Changed

- **ESG investing is different from using an exclusionary screen**
- **Data show that results from SRI funds are neutral or positive when compared with non-SRI funds**

DOL Bulletin 2015-01

“fiduciaries should appropriately consider factors that potentially influence risk and return” and “environmental, social, and governance issues may have a direct relationship to the economic value of the plan’s investment.”

Duty of Loyalty

Duty to act in the best interests of

- Private trust – beneficiaries**
- Charity – mission**
- Pension – participants**
- University endowment - university**

UPIA Comment

No form of so-called “social investing” is consistent with the duty of loyalty if the investment activity entails sacrificing the interests of trust beneficiaries—for example, by accepting below-market returns—in favor of the interests of the persons supposedly benefitted by pursuing the particular social cause.

Mission-Related Investing

- **Investment by a charity that has a dual purpose: mission and financial**
- **Restatement of Trusts: “Social considerations may be taken into account in investing” if the social issue or cause relates to the charitable mission or if the decision can be justified as advancing, financially or operationally, a charitable activity conducted by the trust.**

Program Related Investments

Private foundations cannot hold jeopardizing investments but PRIs are an exception:

- **primarily for a charitable purpose**
- **not primarily for investment purposes**

IRS Notice 2015-62

Mission-related investment is ok

- **even if not primarily program-related**
- **even if returns are less than expected for investments unrelated to mission**

Duty of Impartiality

- **Duty to future beneficiaries**
- **Consider long-term investment time horizon**
- **Consider long-term needs of beneficiaries (for a healthy environment)**

Does ESG Investing Breach Fiduciary Duties?

- **Does not necessarily result in lower returns**
- **May improve returns on risk-adjusted basis**
- **Changes focus of investment decisions to long-term benefits**

What's Next

- **Drafting – provide flexibility for trustees or directors**
- **Choosing an investment advisor**
- **More funds available, including index funds**
- **Reporting still inadequate**
- **Impact is hard to measure**

Bottom Line

A prudent investor can (and perhaps should) consider ESG factors as part of an overall investment strategy that considers financial and material extra-financial information.

My Articles – Cites to Studies

***Best Interests in the Long Term*, 90 UNIV. OF COLORADO L. REV. (forthcoming) (SSRN: <http://ssrn.com/abstract=3149856>).**

***Values and Value: University Endowments, Fiduciary Duties, and ESG Investing*, 42 J. OF COLLEGE & UNIV. L. 247 (2016) (SSRN: <http://ssrn.com/abstract=2656640>).**