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Socially Responsible Investing: What Fiduciary Investment Boards Need to Know

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Executive Summary

Socially responsible investing (**SRI**) (also called sustainable, responsible, impact investing) is growing in markets around the world. It offers investors the opportunity to ensure that their investments align with their mission and values and is part of a wider movement to make the global financial system more effective in mobilising capital towards an environmentally sustainable and socially inclusive economy, that is, sustainable development. As SRI is becoming better understood and more widely accepted, the historic barriers to SRI, such as the belief that it is inconsistent with the fiduciary obligation of loyalty to beneficiaries because it has a negative impact on returns, are being challenged and arguably dismantled.

This paper aims to help those boards charged with overseeing investments for the benefit of others (ie. fiduciary boards) in commercial retirement plans, foundations and charities (for the purpose of this paper referred to as **Investment Stewards**) understand what SRI is and how it fits in with their fiduciary obligations and investment governance practices.

Introduction to SRI

SRI is the incorporation of social, ethical, moral, religious, environmental or political criteria into an investment strategy, while still achieving financial goals. Under an SRI approach, maximisation of the trade-off between risk and return is no longer the only guide to investing.

History

The UN Principles for Responsible Investment aim to create an efficient, sustainable global financial system that rewards long-term, responsible investment and benefits the environment and society as a whole.

PRI | Principles for Responsible Investment

There have been numerous cases where retirement plans had stakes in companies making ammunitions or tobacco or mining oil via their fund manager. The ensuing public outcry has often resulted in the fund manager agreeing to work with the relevant plans to revise the investment line-ups. These events can be understood as part of a bigger picture: a global shift in investors' awareness of the impact of their capital on their communities and our world and the ever-increasing promotion of SRI in the investment industry.

Forms of SRI have been encouraged by many religions for centuries, but the roots of modern-day SRI can be found in the heated political climate of 1960s United States. Turbulent social themes such as the civil rights, anti-Vietnam war and feminist movements heightened American investors' awareness of the positive or negative impact their investments can have on society. Factors central to SRI expanded to include labour and anti-nuclear issues in the 1970s and anti-apartheid issues in the 1980s. More recently, climate change and sustainability have become key drivers of investors seeking to invest responsibly. In recognition of the role financial institutions should play in building a more sustainable world, the United Nations Environment Programme Finance Initiative (**UNEP FI**), a partnership between the United Nations (**UN**) and the finance industry, was formed in 1992. In 2005, sustainability spurred then UN Secretary General Ban Ki-Moon to convene investors from around the world to devise the Principles for Responsible Investment (**UNPRI**). These principles aim to create an efficient, sustainable global financial system that rewards long-term, responsible investment and benefits the environment and society as a whole.

Today, SRI continues to grow quickly. As at 2015, nearly 22% ($8.72 T) of funds under professional management in the United States were involved in some form of SRI, following an increase of responsibly invested assets by 76% between 2012 and 2014 alone.[1] In Australia, nearly half of funds invested in Australia at the end of 2015 (AU$633 billion) were invested responsibly.[2] As at the end of 2015, NZ$78.7 billion was invested responsibly in New Zealand, following an increase of 28% from 2014.[3] Crown financial institutions, such as the New Zealand Superannuation Fund and Accident Compensation Corporation, are taking the lead in the SRI space and account for 72% of the responsibly invested funds in New Zealand.[4] Consumer demand is following and investment managers are beginning to respond by developing SRI products across both managed funds and superannuation funds.[5]

How does SRI work?

It is important for Investment Stewards to ask the right questions of fund managers and advisors before retaining them for SRI services. Doing so will help establish whether these service providers are engaged in SRI for the right reasons and to a degree that is acceptable and appropriate for the investing organisation.

Investment managers and investment stewards of some larger fiduciary entities employ various approaches to SRI to varying degrees. The approaches include:

- **ESG integration:** When considering an investment, investment managers systematically consider the company's environmental and social impact and corporate governance practices in addition to carrying out traditional financial analysis. The basis of this approach is the belief that environmental, social and governance (**ESG**) factors affect the financial performance of investments.

- **Screening:** There are three kinds of screening: positive, negative and norms-based. Positive screening (also known as best-in-class screening) involves identifying companies in different industries with superior ESG performance relative to their industry peers. Negative screening involves the systematic exclusion of certain companies, industries, practices or countries from a portfolio. Common examples include avoidance of investments relating to gaming, alcohol and tobacco. Norms-based screening involves the exclusion of companies that do not meet minimum standards of business practice derived from UN conventions, such as the Convention on Cluster Munitions.

- **Shareholder advocacy:** Under this approach, fund managers use their influence as shareholders to engage companies on ESG issues and promote change. The tools at the disposal of fund managers include engaging directly with boards or senior management, filing shareholder resolutions and using shareholder voting powers in a deliberate way.

- **Sustainability themed:** Some SRI funds focus specifically on sustainability, for example, by avoiding investments relating to extraction or distribution of fossil fuels and investing in clean energy, green technology and sustainable agriculture or water technology.

- **Impact investing:** This approach involves investing in companies that aim to solve a social or environmental issue, for example, poverty. Both tangible social or environmental impact and financial returns are measures of success under this approach, which is popular overseas with high net worth individuals, charities and foundations. It is growing rapidly in Australia, where AU$3.7 billion was involved in some kind of impact investing by the end of 2015, having increased by 74% from 2014.

ESG integration, negative screening and shareholder advocacy are the most common approaches internationally and advisors and fund managers often combine different approaches.

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[1] US SIF Foundation, *Report on US Sustainable, Responsible and Impact Investing Trends* (Washington DC: US SIF, 2014 (biannual report))

[2] Responsible Investment Association Australasia, *Responsible Investment Benchmark Report 2016: Australia*, available from www.responsibleinvestment.org

[3] Responsible Investment Association Australasia, *Responsible Investment Benchmark Report 2016: New Zealand* (Sydney: RIAA, 2016), available from www.responsibleinvestment.org

[4] Responsible Investment Association Australasia, *Responsible Investment Benchmark Report 2016: New Zealand*

[5] Responsible Investment Association Australasia, *Responsible Investment Benchmark Report 2016: New Zealand*

It is important for Investment Stewards to ask the right questions of fund managers and advisors before retaining them for SRI services. Doing so will help establish whether these service providers are engaged in SRI for the right reasons and to a degree that is acceptable and appropriate for the investing organisation. It will also help ensure that the service providers are aware of the investing organisation's mission, values, financial goals and reasons for having an SRI strategy and that their processes align with these factors.

Fiduciary Obligations – No Longer an Obstacle to SRI

What are fiduciary obligations?

Fiduciary obligations are imposed on people that exercise some discretionary power on behalf of others (beneficiaries) in circumstances that give rise to a relationship of trust or confidence. For example, Investment Stewards owe fiduciary obligations to the beneficiaries of their organisation and investment advisors and fund managers owe fiduciary obligations to their investing clients. Fiduciary obligations include the duty of care, which requires that fiduciaries act with due care, skill and diligence, and the duty of loyalty, which requires (among other things) that fiduciaries act in the best interests of the beneficiaries. An important part of the duty of loyalty in the investment context (especially the superannuation context) is the obligation to hold the investments in trust for the long-term financial benefit of beneficiaries and no other purpose.

The common interpretation of what fiduciary obligations require with regards to acting in beneficiaries' best interests and the belief that SRI negatively impacts returns are changing. Fiduciary obligations can no longer be cited as a legitimate barrier to SRI.

Why have fiduciary obligations been seen as an obstacle to SRI in the past?

A report entitled *Fiduciary Duty in the 21st Century* recently published by the UNPRI, UNEP FI and the UN Global Compact (**UNPRI Report**)[6] identified several obstacles to progress in SRI. Perhaps the biggest obstacle in the past has been the widespread belief that the fiduciary obligations (particularly, the elements of the duty of loyalty described above) of fund managers and Investment Stewards prevent them from taking ESG factors into account in their investment processes or otherwise engaging in SRI. This belief has been underpinned by the argument that, in the investment context, to act in "beneficiaries' best interests" means to act in their financial interests only and SRI is inconsistent with this because it negatively impacts performance. This argument is thought to be a consequence of the predominance in the early years of modern SRI of negative screens, which were thought to automatically penalise performance through reducing fund diversification.[7]

However, the common interpretation of what fiduciary obligations require with regards to acting in beneficiaries' best interests and the belief that SRI negatively impacts returns are changing. Fiduciary obligations can no longer be legitimately cited as a barrier to SRI.

How are beliefs about fiduciary obligations in the SRI context and the impact of SRI on investment performance changing?

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[6] United Nations Principles for Responsible Investment, United Nations Environment Programme Finance Initiative, United Nations Global Compact, *Fiduciary Duty in the 21st Century* (London: UNPRI, 2015) available from www.unpri.org

[7] Asset Management Working Group of the United Nations Environment Programme Finance Initiative and Mercer, *Demystifying Responsible Investing Performance: A review of key academic and broker research on ESG factors* (UNEP FI, 2007), available from www.unepfi.org

In 2005, top-tier international law firm Freshfields Bruckhaus Deringer (**Freshfields**) was commissioned to conduct a legal analysis of whether fiduciary obligations really were the obstacle to considering ESG factors in investment decisions that they were commonly believed to be. Freshfields concluded, controversially at the time, that fiduciaries' consideration of ESG factors in investment decisions is "clearly permissible and is arguably required".[8] Building on this conclusion, the UNPRI Report argues that society and the economic and market environment in which investment fiduciaries operate are changing due to factors such as globalisation, population growth, natural resource scarcity, the internet, social media and changing community and stakeholder attitudes. Consequently, it argues, ESG factors are becoming more and more relevant to investment risk and return and the scope of fiduciary obligations is changing to reflect this, imposing a positive duty to consider these factors in investment processes. **This is important given that fulfilment of fiduciary obligations is tested legally by reviewing the process followed to arrive at a decision, not the ultimate decision.**

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ESG integration is now the dominant approach to SRI (often in combination with other approaches) and there is a significant body of evidence, including academic, industry and UN-sponsored studies, showing that ESG factors contribute to long-term value creation. The UNEP FI has reported that ESG factors can in fact have a positive impact on investment performance or at least a neutral impact.[9] It has also reported that ESG issues affect shareholder value both in the short and long term and that the impact of ESG issues on share price is quantifiable.[10] The Responsible Investment Association Australasia (**RIAA**) has assessed the performance of Australian SRI funds (Australian equities, international equities and multi-sector growth funds) that apply ESG integration and one or more of the other SRI approaches. The RIAA found that the SRI funds mostly outperformed their benchmark index and average performance of equivalent mainstream funds when measured over one, three, five and 10 years.[11]

Regardless of the impact of SRI on investment performance, it is also now argued that what constitutes beneficiaries' best interests can be wider than just financial interests and that fiduciaries must take into account their beneficiaries' view as to what their interests are.[12] This means that Investment Stewards should be clear with investment managers and advisors about whether the purpose and values of their organisation mean that ESG integration and/or another SRI approach are in its best interests. Sometimes, an organisation's governing documents require Investment Stewards to incorporate an SRI approach into their investment decisions and not doing so will be a breach of their fiduciary obligations. It is important that Investment Stewards communicate such requirements to their investment managers and advisors.

Therefore, instead of being a barrier to SRI, fiduciary obligations (particularly the duty of loyalty) should in fact be one of the main drivers of SRI. This is especially true for organisations (for example, sovereign wealth funds) whose investment focus is frequently very long-term, because ESG factors, particularly environmental factors, will have an impact on the future relevance and value of today's companies.

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[8] Freshfields Bruckhaus Deringer, *A legal framework for the integration of environmental, social and governance issues into institutional investment* (London: United Nations Environment Programme Finance Initiative, 2005), available at www.unepfi.org
[9] UNEP FI and Mercer, *Demystifying Responsible Investing Performance*
[10] Asset Management Working Group of the United Nations Environment Programme Finance Initiative, *Show Me The Money: Linking Environmental, Social and Governance Issues to Company Value* (UNEP FI, 2006), available from www.unepfi.org
[11] RIAA, *Responsible Investment Benchmark Report 2016: New Zealand*. The only measurement showing slight underperformance was the SRI international equities funds in the short-term only (one and three years).
[12] UNPRI, *Fiduciary Duty in the 21st Century*

A Turning Point for SRI – The New Norm?

The investment industry is in a period of transition and, over time, SRI is only going to become better understood, more effectively executed and more mainstream.

While there are still some obstacles to be overcome in the investment industry for SRI to become a mainstream investment approach, SRI is gaining widespread acceptance and it is growing rapidly around the world. Attitudes towards SRI in the industry worldwide are changing due to Freshfields' conclusive legal analysis that SRI is consistent with and arguably required by fiduciary obligations, the large body of credible research disproving the belief that SRI undermines investment performance and the increased accessibility of ESG research. The UN has engaged with SRI as an essential part of sustainable development through initiatives such as the UNPRI, UNEP FI and the UN Global Compact. There has also been engagement at a national level in some jurisdictions, such as the United Kingdom and Japan, and in the European Union, where governments and industry bodies recognise the importance of moving towards SRI, sustainability and a long-term view in capital markets. Finally, there is increased engagement with and a huge drive in demand for SRI at a societal level as, now more than ever, individuals realise that investments have impact and seek to do good in society. This is especially acute in the millennial generation (born between 1980 and 2000), who generally seek to reflect their values in every aspect of their lives: their jobs, the products they buy, the organisations to whom they donate their time and money and, of course, the investments they make.

All of this shows the investment industry is in a period of transition and, over time, SRI is only going to become better understood, more effectively executed and more mainstream. Currently, there is not yet a large range of SRI product options and some of those that are available can be expensive due to the extra tasks imposed by proper SRI and their relatively smaller assets under management. Also, the motivations of advisors and fund managers in engaging with SRI can sometimes be questioned and some funds appear to be responsibly invested but the reality is quite different. Investors should be aware of these issues and remember that doing proper due diligence before investing is key.

What Does This Mean for Investment Stewards?

For Investment Stewards that are interested in making a difference in the world through their investments, as they do through their everyday activities, now is a good time to look at SRI. This is true for many reasons, some of which are:

- **Impact:** SRI allows investing organisations to align their investments with their values and purpose and the values of their stakeholders and have a positive impact on society through the responsible allocation of their capital.

- **Financial benefit:** If done well and with proper due diligence, organisations can arguably expect to receive returns equal to or higher than returns derived from comparable non-SRI funds. Also, aligning investments with the values of their stakeholders means these organisations can capitalise on the increasing desire of individuals to do good in society by making sure they do not alienate donors. The more donations an organisation receives, the greater impact it can have through its charitable activities.

- **Reputational risk:** Engaging with SRI now could reduce any current reputational risk arising from the media or the organisation's stakeholders noticing inconsistencies between the organisation's purpose and its investments. Also, engaging with SRI could future-proof the reputation of the organisation and its Investment Stewards. Future trustees, donors, beneficiaries and other stakeholders of the organisation will judge disregard for SRI with the benefit of hindsight and there could be a reputational risk to not taking action now to invest responsibly.

Investment Stewards must view SRI through the lens of their fiduciary obligations and proper investment governance process. Therefore, there are several important practical considerations for Investment Stewards in adopting an SRI strategy. Briefly, these considerations include:

- whether SRI is appropriate for the organisation, taking into account relevant governing documents, donors' wishes, the organisation's values and purpose and other factors;
- designing an SRI philosophy and strategy that best suits the organisation's financial and SRI goals;

- ensuring the SRI strategy is properly documented;
- conducting thorough due diligence and knowing which questions to ask before engaging an investment service provider to carry out the SRI strategy; and
- ensuring Investment Stewards have the processes in place and the knowledge and understanding necessary to properly monitor SRI investments and service providers.

Conclusion

SRI is becoming better understood, better executed and more mainstream and is consistent with the fiduciary obligations organisations and Investment Stewards owe to their beneficiaries. Investment Stewards of organisations wishing to incorporate an SRI strategy into their investment processes must do so in a way that fulfils their fiduciary obligations and complies with best investment governance practice, and can enjoy numerous benefits from doing so. The organisation can align its investments with its mission and values, minimise reputational risk, engage with beneficiaries and donors who also seek to do good in the world and join in the global push to direct capital towards well-governed, sustainable, socially-minded companies. Importantly for Investment Stewards, all of these benefits can be pursued along with realistic expectations of achieving returns that are better than, or at least equal to, returns derived from non-SRI investments.

Further reading: The reports referred to in this paper contain useful information about SRI. For our view on the practical considerations for investment fiduciaries interested in SRI, see our paper entitled *Socially Responsible Investing: Practical Advice for Fiduciary Investment Boards Considering SRI*.