SOCIALLY RESPONSIBLE INVESTING – A UNIQUE APPROACH FOR NFPS AND PHILANTHROPISTS

PERPETUAL IMPACT
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Few groups are as eager to align their investments with their values as philanthropists and not-for-profits (NFPs). These groups have been a key driver of 'Socially Responsible Investing' (SRI) which has emerged as a pragmatic and profitable investment framework.

We've seen increased private-sector focus on the United Nations Sustainability Development Goals (SDG), as well as burgeoning altruism from the millennial generation, leading to increased scrutiny from both consumers and investors on how companies operate.

The team at Perpetual Private has been part of this evolution, and in this edition of IMPACT, we're looking at the principles, the options and the pitfalls of SRI.

WHAT'S DRIVING GROWTH?

Recent research from the Responsible Investment Association of Australia (RIAA) suggests 9 in 10 Australians expect their investments to be managed responsibly and ethically.

As Scott Hawker, Perpetual's National Manager of NFP Endowments, explains; NFP boards are more aware than ever of the impacts, and the optics, of the companies in which they choose to buy stock.

"There's an obvious desire to avoid potential conflicts of interest with the organisation's core mandate, but it's now moving beyond that - philanthropists want to ensure their investments are not negating the good work they do day-to-day.

Every organisation has its own set of values and they want to know their investments are aligned, whether that be avoiding companies that contribute to climate change, promote obesity or stifle gender equality, to name just a few," Mr Hawker said.

THE ABC OF SRI, ESG, PRI & IMPACT INVESTING

As the sector evolves, NFP boards and philanthropists are faced with questions around which ethical or mission-related lens they should apply to their funds to best achieve their goals. Here, we look at some of the most common approaches.

Socially Responsible Investing – SRI

SRI refers to investing that takes into account a company's 'responsible' footprint, using measures such as industry classification, the amount of revenue that may be generated from certain undesirable activities or the amount a company positively contributes to society. This could take the form of a 'negative screen' which may exclude stocks in tobacco, arms and fossil fuels industries, or a 'positive screen', that may overweight positions in stocks that generate renewable energy, actively reduce carbon or address social problems.

Environmental, Social & Governance – ESG

ESG is a lens through which companies are assessed on these three factors in addition to a stock's potential financial performance; hence the moniker 'non-financial factors'. Environmental factors might include activities that contribute to climate change or a company's 'carbon footprint', social factors could capture human rights abuses in a supply-chain and governance can cover everything from diversity on boards to gender equality.

United Nations Principles of Responsible Investing – UN PRI

PRI is an initiative from the United Nations that encourages asset managers and owners to factor in responsible investment (RI) principles when making investment decisions. Signatories to the UN PRI will have a responsible investment policy in place and actively take RI factors into account in their investment process. Signatories are audited each year to ensure that these principles are being upheld. Perpetual is a signatory to the UN PRI.

Impact Investing

Impact investments take this a step further – they're investments that are intended to have a positive impact on society (they go that are intended to have a positive impact on society (they go beyond 'do no harm' to actually do good). There is a financial return but also a positive social or environmental return. They might include loans for a renewable energy project, investments in microfinance start-ups, or structured finance in support of childhood education (which could be delivered via 'social bonds', or 'pay-for-results' contracts between a social provider and government).

THE PERPETUAL PRIVATE PROCESS AND PHILOSOPHY

The Perpetual Private team has combined long experience, rigorous analysis and feedback from clients to develop its in-house SRI model. This model is at the heart of the Direct Australian Equities – Responsible Investment Portfolio which is available to private clients and NFPs. Every stock in the fund is analysed with a quality filter, an ethical filter and an ESG filter.

Individual stocks can also be added to a portfolio. They're chosen with the same level of due diligence, but with the added customisation of considering a client's unique situation and sensitivities.

Exposure to other asset classes using a SRI approach, such as offshore equities and fixed income, is also possible as the team applies its ESG eye to a range of professional asset managers, many of which are also UN PRI signatories.

Analytical depth comes from a long-standing relationship with CAER, a consultant to the investment industry that provides research on ESG and ethical performance issues. Perpetual also has a substantial relationship with Cambridge Associates, based in Boston, which provides advice to major endowments including many not-for-profit organisations.

These activities are all captured in Perpetual Private's Responsible Investment Policy which defines its emphasis on incorporating ESG issues into investment analysis, reviewing the ESG policies of external managers and managing any material issues through engagement, voting and in some cases divestment.

Building bespoke portfolios

Perpetual Private works individually with each of its clients to understand their needs and establish the level of SRI intensity that is appropriate for their portfolio. We consider a range of factors including:

- The investment return goal
- The fiduciary responsibilities of the directors
- The potential to limit returns through constraining investment selection
- The practicality of diversification across large portfolios
- Transparency with respect to underlying investments in funds and any particular sensitivities

YOU DON'T NEED TO TAKE A HAIRCUT

The idea that investing with a sustainability focus leads to lower returns is a myth.

Sustainability is all about long-term thinking which should lead to better long-term returns. Research from Morgan Stanley has shown that ESG funds are regularly beating their mainstream benchmarks.

Of course past performance is no guide to future performance, but these strong returns have caused a major rethink of long-held financial models. ESG factors now sit beside financial performance as a vital performance indicator.

It must also be noted that the narrowing of investible options does have the potential to impact returns. Highly cyclical sectors, such as mining and resources, which are not in the SRI portfolio, can sometimes deliver spurts of outperformance that may boost the relative results of non-SRI portfolios.

Short-term comparisons can make SRI investors question their choices, but when viewed across longer time horizons there is growing evidence that SRI funds do not require a lower relative return expectation.

INVESTING WITH IMPACT

Risk mitigation is a key reason for assessing investments beyond simply financial factors. But equally important are its social and environmental impacts. A raft of new financial strategies are achieving ground-breaking results, while offering investors ever-more accurate impact data and insights.

Social impact bonds combine the efficiency and entrepreneurialism of the private sector to solve problems that would otherwise depend entirely on government funding. In NSW, the state government has pioneered a number of social impact investments targeting: out-of-home care, prisoner re-offending, mental health, chronic health and youth homelessness.

According to Ben Gales, Executive Director of NSW Treasury's Economic Strategy Division, these investments represent more than $200 million in outcomes-based contracting.

"Structures like the Newpin Bond and the Resilient Families initiative through the Benevolent Society have certainly been a success. Just looking at the outcomes for kids and their families, we've seen more than 60 per cent of children restored to their families, which is far above the close to 20 per cent level seen in business as usual.

So that's transformative for the families, and at the same time we're delivering savings for the government. Going forward they'll require less welfare which is good for the taxpayer. And of course with part of the avoided cost we're able to pay investors a return; their role is vital as they provide the risk capital up-front." Gales explains.

After five years of solid results the social bond structure is receiving broad support.

"Originally in 2013 we were tentative, wondering how much demand there would be from investors. But that fear was unfounded, we're now seeing bonds in Queensland, South Australia and Victoria. It's evidence that there's significant demand for these types of investments" Gales says.

An ability to effectively measure impact is vital here, and the gains are being seen right across the government.

"These transactions are about more than the outcomes for the kids, and more than the investment return, it's about an evidence base of what works so we can scale that success. We've learned a huge amount about impact measurement and how we track outcomes, which is now being used across the board in the NSW government." Gales explains.

SRI IS BECOMING THE MAINSTREAM

In the broader market, it is becoming clear that sustainable practices are being adopted as simply good business, rather than being costly but ethical 'nice-to-haves'. The result is a heightened sensitivity to a business' impact. While the Perpetual

Private team continues to intensify its analysis and offer profitable and sustainable investment options, there is a growing optimism that SRI will broaden and deepen across investor portfolios.