An Alternative Approach to Responsible Investing

On Thursday evening, May 18, 2017,
CAIA's Boston Chapter held a panel discussion
at the InterContinental Boston on
"An Alternative Approach to Responsible Investing."

Moderated by Bill Kelly, CEO
CAIA Association

Panelists included leading ESG investing experts

Tim Brennan, Treasurer & CFO
Unitarian Universalist Association

Jeff Finkelman, CFA, Research Associate, Impact Investments
Athena Capital

Lee Gardella, Managing Director, Head of Risk Management
Adveq Management

Responsible Investing, including the incorporation of environmental, social and governance (ESG) factors and ethical principles, is growing in importance in the alternative investment management industry. In a recent survey by CAIA and global institutional private equity investor Adveq, more than three quarters of respondents agreed that Responsible Investing will become even more relevant in the years ahead, driven by ethical principles, constituent demands, and new business opportunities. This survey provided the backdrop to the discussion.

Following is an edited Q&A of the panel discussion.

Bill Kelly:

Is ESG a risk to be managed or a product?

Lee Gardella:
It's risk management. It's a risk framework. These are key factors for anyone allocating in the long term. When you have a long term equity investment, you must begin with the philosophy of the firm. Responsible Investing must be part of a firm's philosophy and process, and a firm must have a framework in place to make investments and monitor investments to have an impact and create value. So, it's not a product, it needs to be a fundamental component of the investment process from philosophy, objectives, strategy, investment and monitoring processes. To Adveq, it's a fundamental piece of how you invest in private equity for the long term.

Tim Brennan:
We view ESG as a social good. We're a faith-based group so it starts with our values. We want to reflect our values in the way we invest our money, balancing risk return and justice. We want excellent risk adjusted returns. It's very important for it to be a successful investment program. We don't believe we've sacrificed anything.

In public equity, we have a fund. It's a benchmark fund custom designed to track the Russell 1000 that skews the portfolio to better ESG companies and screens out the bottom 20% and the returns are right on the index, so there are no sacrifices.

Our endowment fund is half our money - we're the denominational headquarters. The other half is investments from congregations. Our Responsible Investing focus is a huge plus. It's why they want to be in the fund, because we bring ESG principles to all decisions we make. We're an active investor and we use our assets to advocate with companies for better environmental and social policies.

Jeff Finkelman:
About a quarter of our clients have some exposure to Impact Investments. I use that term broadly to incorporate ESG, SRI and true Impact. There are many different views

about what Impact means. At Athena, we spend a lot of time thinking about how to segment the market and classify the market to connect the right strategy to the right client. For some, it's about an alpha opportunity, and for others, it's about values alignment, or driving environmental and social outcomes without sacrificing returns.

Bill Kelly:

As an analyst, how uniform is the data?

Jeff Finkelman:
So that is a big impediment. In some ways it ties back to ESG as a source of alpha. The jury is out because everybody has different definitions of what ESG means. What we focus on when evaluating a particular ESG investment opportunity is to understand the manager's process, where they get their data and how they use it.

Bill Kelly:

A key theme in the private equity space is lack of measurement tools. How is that affecting adoption?

Lee Gardella:
The lack of measurement tools is an impediment to adoption as it hinders an organization's ability to provide quantitative proof. However, the institutionalization of ESG is early in its development. Furthermore, private equity capital is more patient and there needs to be a long-term approach. We can't expect miracles overnight for sure. We need to assess General Partners' abilities to make an impact on those businesses whether it is in private equity, venture capital or turnaround. There are wide-ranging interests and perspectives on ESG. Some firms can't even spell ESG. The core philosophy behind the ESG framework is to recognize and not violate investors' values.

Jeff Finkelman:
ESG themes are long-term themes and take time to play out. We are looking for managers that do have longer-term hold periods and evaluate how the issues will play out over multiple years. As ESG grows in the marketplace it will help foster a longer-term mindset.

Tim Brennan:
The Unitarian Universalist Association is all externally managed money. We are a long-term investor. I have funds and trusts that date back to 19th century. We aim to grow the assets perpetually. ESG measures are better indicators of long-term value. We're concerned with long-term value creation, so we are less concerned about what happens in the latest quarter. How do you measure long-term value creation? There's no EPS estimates for what will happen in 10 to 20 years, never mind 50 years. Responsible Investing has made tremendous progress over the last 20 years. Then we had the UNPRI Principles, and now we have big research firms like Sustainalytics that are helping us assess ESG opportunities and success. As ESG grows, there will be more demand for the data, and more pressure to produce the data.

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> *Lee Gardella, Managing Director, Head of Risk Management, Adveq Management*

> *"I believe in the private equity and private capital space there is more opportunity for Impact."*
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> *Tim Brennan, Treasurer & CFO, Unitarian Universalist Association*

Bill Kelly:

Who is responsible for data collection and measurement?

Tim Brennan:
Ultimately it's users asking for it. There used to be voluntary reporting to GRI, then there was pressure on the SEC to mandate it. They added rules about the disclosure of climate risk for example. The smaller firms have voluntary reporting issues, and as you move up the pyramid it becomes expected, then mandated by exchanges, which is happening, then mandated by regulators. That's how it's working. It's becoming more refined through process and iteration.

Bill Kelly:

Is there too much product in the marketplace? Consider liquid alts as an example. With monetary policy and low-volatility, a lot of managers flooded the market with product.

Jeff Finkelman:
We don't provide products. I think there's some risk. We see a lot of Impact products in the market and it's easy to slap a label on a product and say it's ESG or it's Impact because we care and the GP gives some of their carry to charity. There are a lot of different approaches. As it expands, it's important to maintain standards. The work that SASB, the Sustainability Accounting Standards Board, is doing – particularly around materiality – goes back to long termism. If a company is in a particular sector, there are ESG factors that matter to that industry – there's data.

Lee Gardella:
Responsible Investing is ever present in Europe. There is not one investor that doesn't think about it. The clients we work

with expect managers to have a framework in place. The United States is clearly behind. There are pockets of activity clearly, but funds have less resources. Although public pension funds are beginning to push forward on this topic. With our Asian clients there is very little, if any, conversation about ESG.

Bill Kelly:

Has the Department of Labor been clear enough about ESG and investors' fiduciary duties?

Lee Gardella:
For U.S. investors, yes. Fiduciaries are comfortable that ESG factors are a construct that should be considered, but they do recognize that ESG are key factors for long-term wealth preservation and creation along with other factors.

Bill Kelly:

What is your view on public company proxy voting on ESG issues?

Tim Brennan:
We can vote our proxies for equities in separate accounts – 30% of our portfolio is in separate accounts, and we can vote the stocks. When we're picking the managers, we are seeking managers who are consistent with our approach if we did it ourselves. For all U.S. equities, we are voting in every proxy through ISS. We give them very detailed instructions and they vote every proxy in line with our values. If enough ESG proxy votes are cast even if an initiative is voted down, the company often views it as a vote of no confidence, and the next year the company will say let's talk. Support for change can take many years, but builds over time.

Bill Kelly:

Where do you see the greatest ESG investing opportunities?

Lee Gardella:
Most of the companies Adveq invests in are lower middle market buyouts and early stage venture, so relatively smaller firms and funds. We believe opportunities exist among all investment firms and companies to apply specific components of the ESG principles. However, it would seem companies that utilize natural resources have the most to gain. For instance, we are investors in a company focused on vehicle fleet and restaurant kitchen hood cleaning, whereby water usage is a meaningful component of their service. Our company has differentiated itself by its ability to efficiently recapture, treat and recycle the water used in its business.

Jeff Finkelman:
We see a lot of VC opportunities. That's a very rich space for Impact partly because VCs are investing in exciting and innovative business models. I would point to microfinance, which is more established in the Impact market and is shown to not be very highly correlated with other asset classes. Even if they are investing in frontier markets and dealing with currency risk, microfinance can provide steady returns and the Impact story is pretty strong.

Tim Brennan:
I think in the public space it's hard to demonstrate impact. I believe in the private equity and private capital space there is more opportunity for Impact. We made an investment with a group called Brockton Capital Management in the U.K. The management team is from the Boston area and named the company after Brockton, MA. They buy existing commercial real estate that is tired but is always near public transportation, and then they renovate it to high energy-efficient standards and then resell it. They never use the terms ESG or Impact. We saw that and liked the opportunity. Forty percent of greenhouse gas comes from buildings so it is an important thing to address.

Bill Kelly:

Third party groups are trying to measure Impact. What is better, the quantitative results of Impact investing, or a close philosophical alignment of interests?

Lee Gardella:
At this stage of institutional adoption of ESG principles, we believe a close philosophical alignment of interest is the first priority. Once this is in place, quantitative results will follow. Any fund we invest in, we set goals, two or three things they can make progress on. If they are a new investment, we will want to see their Responsible Investment policy and how it affects their screening. We want to see progress across the portfolio.

Tim Brennan:
I'm interested in numbers. We just created a carbon footprint analysis on our portfolio. It's interesting to see how your own portfolio companies impact climate through emissions and how you compare to a benchmark. It's good to see the results. They were way below the benchmark. It's good to see it was actually validated by our carbon footprint analysis.

Jeff Finkelman:
With regard to Impact, measurement is very important. If a manager is saying they're doing an Impact strategy, they must explain what they're measuring. The challenge is that because every strategy is different we can't dictate to the manager what they should be doing. The volume and quality of data a manager provides is also a matter of negotiation. GPs may be willing to accommodate the data needs of their larger investors. But even if we can't always get the rich data we would want to see, we do want to see a plan.

Bill Kelly:

It used to be the perception that you are giving up returns for social benefits. Is that still the case?

Lee Gardella:
If taken to its extremes, yes financial returns will suffer. Investors have a responsibility to the clients and constituents they are serving, and today more are asking for consideration

to social benefits in addition to the financial return. Thus, a careful balance needs to be established that is guided by a framework that addresses the key issues.

Tim Brennan:
The story has never been true that applying ESG or SRI meant you underperformed. Mercer did a study looking at 40 different studies on the topic and found that there was either no difference or an outperformance of SRI. The original SRI mutual funds or private funds came with very high fees. SRI funds tended to be small so to be able to do SRI analysis meant additional expenses and those were passed along to investors. In the institutional space, we don't pay any extra in fees. We're doing a search, lining them up against others, seeing if they are PRI signatories, seeing if their fees are competitive and if their returns are competitive.

Bill Kelly:

What closing thoughts do you have?

Lee Gardella:
From Adveq's perspective as a global firm that is private equity centric, the movement toward ESG is much greater today than it was three years ago. This horse has left the stable and won't return. It is a construct that investors and individuals must understand going forward.

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Jeff Finkelman:
There is evidence of that in the RIA business. Many people are trying to get up to speed on Impact and hiring staff for positions like mine which focus exclusively on SRI, ESG and Impact Investments. It's a sign of the wealth transfer that's coming. It is becoming part of the investment practice, not a separate practice.

Tim Brennan:
An investment consultant told me he invests a lot of money and research capacity researching ESG managers because he is getting an increasing interest from clients. Endowments and foundations and pension funds are asking about ESG, but there is not a lot of actual investment action. That is the difference right now between the U.S. and Europe. Here, they are inquiring and sticking their toes in the water, but not a lot of clients are actually doing it. But ESG concerns are penetrating more at the company level and affecting their investment decisions driving opportunity to environmental or social outcomes. ■

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