



100 Main Street Suite 301

Safety Harbor, FL 34695

TEL (727) 799-3671 (888) 248-8324 FAX (727) 799-1232

Toward Better Philanthropy: Consistency of Mission and Investment

Jon E. Quigley, CFA

April 2011

Toward Better Philanthropy: Consistency of Mission and Investment

Jon Quigley, CFA
Advanced Investment Partners

Today, investors have a rich set of extra-financial information known as Environmental, Social and Governance (ESG) ratings. Potential investments can be judged not only by their financial statement, but also by their environmental policies and footprint, their governance structure, and their relationship with their workforce and the greater community. Below, we present the case that incorporating environmental, social and governance (ESG) ratings in the portfolio construction process substantially improves Social Return on Investment for mission and faith-based organizations, as well as helping control portfolio risk.

phi-lan-thro-py (noun)

1. desire to benefit humanity

a desire to improve the material, social, and spiritual welfare of humanity, especially through charitable activities

Individual philanthropists, endowments, and foundations alike serve a critical role in a capitalist society. America's earliest and greatest titans of industry – John D. Rockefeller and Andrew Carnegie – defined the structure of modern philanthropy. Rockefeller used his considerable petroleum fortune to target causes such as medicine, education and scientific research. Carnegie used his steel fortune to fund libraries, education, scientific research and to promote world peace.

Today, the Bill and Melinda Gates Foundation is the philanthropic vehicle for America's current titans of industry (Gates and Warren Buffett), giving to causes such as medicine, education, and poverty and development. Countless other philanthropists and religious and not-for-profit organizations are committed to filling the gaps in the government's net, endowing a plethora of causes from providing housing (Warrick Dunn Family Foundation), to supporting the arts and land conservation (The Donnelly Foundation), to human rights and the impact of technology (The MacArthur Foundation).

These individuals and groups invest their personal fortunes along with the generous gifts of donors over many, many years. In order to sustain the impact of the donations, the endowed funds are typically invested in a portfolio of marketable securities, with the growth portion of the fund invested in equities. In an effort to avoid investing in industries with suspect consequences, the investment funds of many mission or faith-based organizations are prohibited from owning stocks of alcohol, tobacco, or gaming companies.

Measuring the Impact of the Endowment Portfolio

The Hewlett Foundation and others have done significant work to advance the scientific measurement of the impact of a dollar after being given by an organization. This impact per dollar is known as the Social Return on Investmentⁱ, or SROI. Effective measurement of SROI

can help build a feedback loop, allowing increased impact per dollar of giving. Holding the size of the endowment portfolio (E_p) and SROI of the grant ($SROI_g$) constant, many view investment return as the only remaining impact lever.

No surprise then that many philanthropic groups seek to maximize the return of their investment portfolio, subject to maintaining enough short-term liquidity to fulfill near-term giving. Here, the beta, market portfolio, and portfolio alpha are the levers for improving investment return:

$$\overbrace{(E_p * \beta_{ep} [E(r_m) - r_f] + \alpha_{ef}) * SROI_g}^{\text{Impact of Investment}} = \text{Impact of Grant}$$

where :

- E_p = size of endowed portfolio, a constant
- β_{ep} = beta of the endowed portfolio
- $E(r_m)$ = expected return of the market portfolio
- r_f = risk free rate of return
- $[E(r_m) - r_f]$ = equity risk premium
- α_{ef} = alpha of the endowed portfolio
- $SROI_g$ = Social Return on Investment, a constant

The benefit of the investment portfolio is often viewed solely as enabling increased giving. While this is indeed a key benefit of a philanthropic organization’s portfolio, it ignores a key component of the investment portfolio’s impact: the Pre-Grant Impact of the funds invested prior to targeted giving.

The Tradeoff: Pre-Grant Impact or Investment Return

About 5% of endowments and foundations do target a portion of their investment dollars toward Mission Related Investments, or investments which are consistent with and/or advancing a cause. Such investments may include below-market-rate investments, in which the expected rate of return is near-zero. An example of such an investment is making low interest business loans with a substantial risk of default in a low-income section of a given municipality. Here, the opportunity cost in the form of below-market-rate return on investment dollars (via a different market portfolio and lower expected alpha) is offset by the positive societal impact (via a positive SROI) of the investment portfolio prior to giving, as indicated by the Pre-Grant Impact shown below:

$$\overbrace{(E_p * SROI_{ep})}^{\text{Pre-Grant Impact}} + \overbrace{((E_p * (\beta_i[E(r_{mbi}) - r_f] + \alpha_{mbi}) * SROI_g))}^{\text{Impact of Investment on Grant}} = \text{Total Incremental Impact from Investment}$$

where:

- $SROI_{ep}$ = the SROI of the endowed portfolio while invested
- $E(r_{mbi})$ = expected return of the mission-based investment market
- α_{mbi} = expected alpha of the mission-based investment portfolio

$$(E_p * SROI_{ep}) = \text{the impact prior to grant, expected to be positive}$$

$$(E_p * (\beta_i[E(r_{mbi}) - r_f] + \alpha_{mbi})) = \text{investment return, expected to be near-zero}$$

For market-rate investments, the total incremental impact equation remains the same. As the name implies, the expected investment return on this portfolio is expected to be substantially higher than that of a below-market-rate portfolio. In this scenario, however, there is a negative SROI on the endowed portfolio while invested, given the investments in companies such as alcohol, tobacco, and gaming companies and the negative externalities associated with their products:

$$\underbrace{(E_p * SROI_{ep})}_{\text{Pre-Grant Impact}} + \underbrace{((E_p * (\beta_i[E(r_m) - r_f] + \alpha)) * SROI_g)}_{\text{Impact of Investment on Grant}} = \text{Total Incremental Impact from Investment}$$

where

$$(E_p * SROI_{ep}) = \text{expected to be negative}$$

$$((E_p * (\beta_i[E(r_m) - r_f] + \alpha)) * SROI_g) = \text{expected to be positive}$$

Balancing Social Return and Investment Return

Most all religious endowments use some form of socially-responsible investing (SRI). SRI traces its roots back to centuries-old religious beliefs. Restricting purchase of stock in tobacco, alcohol, abortion, gaming, and military and defense companies are pervasive “social screens” for these endowments. Endowments and foundations may have negative screens of their own; not owning tobacco stocks is commonplace. Others won’t own stock of military and defense companies, or companies that derive revenue from Sudan. This implementation of social screening curbs the negative SROI of the endowed portfolio while invested, increasing the Pre-Grant Impact. However, it has given rise to the main concern about “socially-responsible investing” for some philanthropic organizations in the US: the fear that the screened investment universe will result in lower returns, resulting in a lower Impact of Investment on Grant. Due to this concern, many view such portfolios in this form:

$$\underbrace{(E_p * SROI_{ssep})}_{\text{Pre-Grant Impact}} + \underbrace{((E_p * (\beta_i[E(r_{ssm}) - r_f] + \alpha_{ssep})) * SROI_g)}_{\text{Impact of Investment on Grant}} = \text{Total Incremental Impact from Investment}$$

where

$$SROI_{ssep} = \text{SROI of socially-screened endowment portfolio, which is greater than the expected SROI of the unscreened endowment portfolio}$$

$$(E_p * SROI_{ssep}) = \text{expected to be zero;}$$

$$E(r_{ssm}) = \text{expected return of socially-screened market portfolio, which is less than the expected alpha of the unscreened endowment portfolio}$$

$$\alpha_{ssep} = \text{alpha of socially-screened investment portfolio}$$

$$((E_p * (\beta_i[E(r_{ssm}) - r_f] + \alpha_{ssep})) * SROI_g) = \text{expected to be positive, but less than the expected impact of the unscreened endowment portfolio}$$

In reality, eliminating investments in companies deriving more than 5% of their revenue from alcohol, gaming, tobacco, military & defense, or companies involved with The Sudan (as measured by KLD Research & Analytics) would only limit the large-cap investment universe by about 5-7% as measured by market capⁱⁱ, and has minimal impact on expected total returnⁱⁱⁱ. The majority of active equity strategies employ some type of investment screen (for example, not buying stocks at above average valuation multiples), and often these screens are far more restrictive. Managers employing such screens would argue they are simply eliminating candidates they deem likely to underperform.

A More Powerful Impact Solution: ESG Integration

These negative screens, while still relevant for certain philanthropic and religious portfolios, are taking a backseat in the rapidly evolving world of sustainable, responsible investing. Environmental, Social and Governance information - commonly referred to as “ESG” - is a rich, rapidly improving field of research and information for investors, and this ESG information is critical for philanthropic groups looking to maximize their total impact.

Earlier, we referenced the substantial breadth of causes targeted by philanthropic groups.

- Does an endowment focused on land conservation want to invest in companies with high levels of emission, or wasteful uses of resources, directly or indirectly lowering the cost of capital for such firms?
- Should a philanthropist targeting medicine and health care make investments in companies which provide little or no health care support, or companies which have a high incident of employee injury or death?
- Does a poverty-focused philanthropic group want to invest in companies with heavily skewed compensation structure, or a philanthropist supporting minority causes make investments in companies with non-diverse boards or current human-rights controversies?

Including such considerations not only curbs the negative impact of the investment portfolio, but also carries real benefits in the form of altering capital costs for a broader swath of public companies. Wide-scale incorporation of ESG considerations will translate into companies with poor operating practices facing substantially higher capital costs, while the best operators should see reduced capital costs. In fact, a portfolio tilted towards companies with the best ESG practices significantly increases the SROI of the endowed portfolio by altering the cost of capital for firms:

$$\underbrace{(E_p * SROI_{esgep})}_{\text{Pre-Grant Impact}} + \underbrace{((E_p * (\beta_l[E(r_{esgm}) - r_f] + \alpha_{esgep}) * SROI_g))}_{\text{Impact of Investment on Grant}} = \text{Total Incremental Impact from Investment}$$

where

$SROI_{esgep}$ = SROI of ESG-integrated endowment portfolio, which is greater than the expected SROI of the unscreened or socially-screened endowment portfolio

$(E_p * SROI_{esgep}) = \text{expected to be greater than zero}$
 $E(r_{nsm}) = \text{expected return of ESG-screened market}$
 $\alpha_{nsep} = \text{expected alpha of ESG-integrated investment portfolio}$
 $((E_p * (\beta_i[E(r_{esgepm}) - r_f] + \alpha_{esgep}) * SROI_g) = \text{expected to be positive, but feared to be less than the expected impact of the unscreened endowment portfolio}$

Risk Benefits of ESG Integration

There are substantial risk benefits to incorporating Environmental, Social and Governance information. Anecdotally, it's easy to understand why investments in companies with poor environmental, social and governance practices are more risky. A company with poor environmental practices may face substantially higher capital expenditures as the government continues to tighten emission standards. In the event of an environmental accident, such a company will face substantial containment, clean-up and reparation costs. A company with employing child labor or placing workforce in high-risk environments, whether directly or in the supply chain faces a substantial risk of consumer boycott and subsequent revenue loss. Finally, a company with a poor governance structure may be more susceptible to untoward or downright fraudulent activity. In each of these instances, the companies may be burdened by higher future litigation costs.

The risk story isn't solely anecdotal, however. Research has shown that not only do companies which rank poorly along ESG lines demonstrate substantially higher return volatility^{iv}, but also that the return volatility is heavily skewed^v. As measured by ESG, poorly rated companies have a higher propensity for extreme negative outcomes.

Return Impact of ESG Integration

Much like in the case of social screening of certain activities, there's concern about the potential for negative impact on return for incorporating ESG information into stock analysis and portfolio construction. "Demystifying Responsible Investment Performance", a Mercer Consulting and UNEPFI review of 20 academic studies reveals only 3 show a negative relationship between ESG factors and portfolio performance. The same study details a review of 10 brokerage reports which reveals none show a negative relationship between ESG factors and portfolio performance. Further evidence that SRI assets have increasing and significant impact on stock returns is contained in a 2007 working paper from the Federal Reserve Bank of Atlanta^{vi}. Watson Wyatt and Russell have also issued supportive studies^{vii, viii}.

Ultimately, then, the fully-integrated ESG portfolio has both a better Pre-Grant Impact and an Impact of Investment on Grant which is equal to or better than that of a market-rate portfolio, and better than a market-rate portfolio when the volatility and tail risk of the investments is considered.

$$\overbrace{(E_p * SROI_{esgep})}^{\text{Pre-Grant Impact}} + \overbrace{((E_p * (\beta_i[E(r_{esgm}) - r_f] + \alpha_{esgep}) * SROI_g)}^{\text{Impact of Investment on Grant}} = \text{Total Incremental Impact from Investment}$$

where

$SROI_{esgep} = \text{SROI of ESG-screened endowment portfolio, which is greater than the expected SROI of the unscreened or socially-screened endowment portfolio}$

$(E_p * SROI_{esgep}) = \text{expected to be greater than zero};$

$E(r_{nsm})$ = expected return of ESG-screened market, expected to be equal to an unscreened market

α_{nsep} = expected alpha of ESG- screened investment portfolio

$((E_p * (\beta_i[E(r_{esgepm}) - r_f] + \alpha_{esgep}) * SROI_g) =$ expected to be as positive as a non-ESG portfolio, and better on a risk-adjusted basis

Conclusion

It's critical for the investment advisor and consultant to build a deep understanding of the endowment or foundation's mission. The optimal ESG-integrated investment portfolio can and should accentuate the specific interests of the philanthropist. While preferable to a portfolio which disregards ESG issues, a one-size-fits-all approach to ESG incorporation will fall short of ideal. Failure to include ESG information results in a less-comprehensive analysis at the security level, a sub-optimal investment portfolio, and less-than maximum impact for the philanthropists' respective missions.

i *SROI Project*. January 27 2011. < <http://www.sroiproject.org.uk/>>.

ii *The Impact of Negative Screening, FA Magazine*. January 27 2011. < <http://www.fa-mag.com/component/content/article/14-features/5161.html?Itemid=131>>.

iii A Quant's Take on ESG, *Responsible Investor Magazine*. September 17 2009. < <http://www.responsible-investor.com/home/article/quant/>>.

iv *Reducing Portfolio Risk Through Sustainable Investing, Advisor Perspectives*. November 16 2010. < http://www.advisorperspectives.com/newsletters10/Reducing_Portfolio_Risk_through_Sustainable_Investing.php>.

v *The Impact of Negative Screening, FA Magazine*. January 27 2011. < <http://www.fa-mag.com/component/content/article/14-features/5161.html?Itemid=131>>.

vi Becchetti, L., Cicretti, R. & Hasan, I. (April 2007), Corporate Social Responsibility and Shareholder's Value: An Event Study Analysis, Federal Reserve Bank of Atlanta Working Paper 2007-6

vii Goodland, Jane. *Investing for the Future*, Watson Wyatt, 2007

viii Collie, B. & Myers, H., "Responsible Investment: Five Tests of an SRI/ESG Policy", Russell Research, August 2008