



BOSTON COLLEGE  
CARROLL SCHOOL OF MANAGEMENT

Center for Corporate Citizenship

Institute for  
Responsible Investment

# Handbook on Responsible Investment Across Asset Classes



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in collaboration with*



Social Investment Forum

# Table of Contents

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Acknowledgements .....	1
Introduction .....	2
Cash and Cash Equivalents .....	6
Fixed-Income .....	18
Public Equities .....	28
Private Equity .....	42
Real Estate .....	54
Hedge Funds .....	68
Commodities .....	78
Note on Emerging Markets .....	85
Selected Readings on Responsible Investment.....	92
Appendix: Links to Organizations and Referenced Readings .....	94

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# Introduction

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Responsible investment—understood as the incorporation of environmental, social, and governance (ESG) analysis into investment decision-making—is a growing discipline that offers opportunities for long-term value creation both for investors and society as a whole.

In recent years, an increasingly large group of investors across the globe has come to believe that key ESG developments—from climate change, to globalization, to the transforming societal expectations for corporations and finance—will have a significant role to play in the long-term performance of investors.

The release of the *United Nations Principles for Responsible Investment*—subscribed to by some of the world’s largest institutional investors, asset managers, and related organizations representing over \$9 trillion in assets as of mid-2007—underscores the widespread acceptance of the principle that investors cannot, in the long run, achieve their goals by investing in corporations that externalize their costs onto society. Many institutional investors have come to believe that superior ESG performance offers potential insight into key elements of the investment process.

This belief is also reflected in the practice of “mission-related investing” (MRI)—investing in financial products that seek to achieve social and/or environmental goals as well as yield market-rate financial returns. Foundation and university endowments, pension funds, socially responsible investors including church pension funds and socially responsible mutual funds, high-net-worth individuals, nonprofits, and others target investments that create long-term societal wealth while also achieving institutional financial objectives. These investment practices align institutional mission with financial goals.

ESG analysis and MRI share a concern with identifying and evaluating investments likely to support the long-term betterment of society. This *Handbook* is designed to offer an overview for investors on how to implement responsible investment in practice, across a range of asset classes and investment styles. Our hope is that this *Handbook* helps interested investors integrate ESG analysis across their portfolios.

## Purpose of the Handbook

Two recent developments prompted us to create this *Handbook*:

- First, there is growing interest in the concept of responsible investment in general, both among individuals and institutions;
- Second, there is recent, increased interest by investors, whether institutions or individuals, in alternative asset classes.

Historically, responsible investment has looked first and foremost to the social and environmental risks and opportunities of investing in the equities of corporations, and a network of sophisticated, socially responsible stock indices, money managers, research firms, and investment products have emerged to help investors integrate ESG information into their public equity investments. Nevertheless, many investors remain unfamiliar with the state of the field.

Compared with public equities, to date relatively little attention has been paid to the ESG implications of investing in other asset classes, and even less thinking has been done on what opportunities for engagement might be available to responsible investors when it comes to fixed income, private equity, real estate, venture capital, or even commodities—despite the fact that each asset class creates its own set of risks and opportunities.

The question therefore arises: How can investors identify and incorporate responsible investment techniques across their portfolios?

Despite many recent and important projects, much work remains to be done to create an overview of how to approach responsible investment across asset classes and how to develop definitions and guidelines for responsible investment across portfolios. Without some general guidelines on what such terms mean, and how such products might serve the varied needs of responsible investors, investors will remain handicapped in assessing the availability and appropriateness of various responsible investment options, and systematic development of the field will remain slow.

This *Handbook* seeks to catalyze growth in responsible investment across asset classes. It is meant to help investors:

- Incorporate responsible investment methods into their investment mandate;
- Identify and evaluate opportunities for responsible investment;
- Coordinate the vocabulary and metrics used to measure ESG impacts.

Each chapter of the *Handbook* focuses on a single asset class and includes information on how to:

- Design a responsible investment strategy for the asset class;
- Identify opportunities for market-rate responsible investments in the asset class;
- Incorporate engagement strategies into the asset class investment strategy.

Our goal is to initiate discussion between asset owners, managers, and investment consultants on the best means to identify and measure the ESG impacts of the full range of responsible investment options that offer market-rate

returns. We believe this *Handbook* can serve as a starting point for examining the rigorous incorporation of responsible investment practices across a range of investment portfolios. This is not meant as a definitive nor exhaustive account of opportunities in responsible investment, but rather as an aid to further encourage activity in an already dynamic field.

## Who should read the Handbook?

Asset owners, money managers, consultants, and related parties will find the *Handbook* useful as they seek to institutionalize responsible investment principles across asset classes. The *Handbook* can provide a framework for discussions about how to incorporate responsible investment into investment mandates and also offers practical information to help target opportunities and evaluate results.

In particular, the *Handbook* will be useful to

- Institutional investors who wish to address the financial implications of long-term ESG risks and opportunities in their investment mandate;
- Mission-related investors—such as foundation endowments, university endowments, and socially-responsible investors—who want to align their investments with their institutional mission, in order both to further institutional goals and manage reputational risk;
- High-net-worth individuals who wish to invest in ways that maximize economic, social, and environmental returns;
- Asset owners, managers, and related professionals who see the creation of social and environmental value, and the mitigation of social and environmental damage, as consistent with their fiduciary responsibilities.

The *Handbook* serves the common interest of these investors in addressing the risks and reaping the rewards that a broad view of investor responsibility entails. There is a rich diversity of ESG investment styles—not every investor will focus on each element of ESG analysis simultaneously. For instance, some will focus on corporate governance relationships between shareowners and managers; others, on the investment implications of climate change; and still others, on achieving community development goals through market-rate investments.

We have designed the *Handbook* to address ESG investment strategies that serve a wide range of investors. We also hope that it will help coordinate the articulation of vocabulary and assessment strategies that will further develop the discipline of responsible investment as a whole.

## A Note on Market-Rate Returns

Responsible investment is not philanthropy, and the strategies and examples that appear in this *Handbook* are not meant to be associated with below-market rates of return. We believe that responsible investment may offer tools to enhance returns by better incorporating long-term ESG concerns into investment decision-making as well as tools to identify environmentally and/or socially beneficial investments that provide market rates of return when compared to widely accepted benchmarks.

This *Handbook* assumes a substantial level of financial sophistication among readers and outlines the ways in which the discipline of responsible investment can enhance traditional financial analysis to support long-term wealth creation for investors and society alike. **By no means do we believe that investors should examine ESG information alone—rather, we believe that the incorporation of these data into financial analysis, when properly applied, brings with it the potential to enhance wealth creation over the long term.**

Finally, in each chapter, we note several existing responsible investment opportunities for each asset class. These are illustrative examples only and not endorsements of any particular investment for any particular institution. (A website link to each institution mentioned in the text is included in the Appendix for the reader's convenience.)

Every responsible investor will examine each potential investment for its risk and return, as well as for its broader implications for long-term wealth creation. We encourage investors to use appropriate, asset-class specific benchmarks to measure the financial performance of their investments.

## Cash and Cash Equivalents:

### Key Opportunities for Cash Deposits:

- Support underserved communities
- Support environmental lending
- Support non-profit organizations
- Enhance financial education
- Support diversity

### Key Tools for Measurement and Engagement:

- Request ESG information
- Advocate CSR
- Link deposits to ESG actions
- Measure social returns

### Key Investment Product Types:

- Community development banks, credit unions, and loan funds
- Mainstream Banks with CSR programs

### Potential Benchmarks:

Market-rates of return are typically determined by comparison to standard industry benchmarks. For Cash and Cash Equivalents, the Merrill Lynch 91-day Treasury Index.

*Note: Investment products and organizations mentioned in this chapter are for illustrative purposes only, and should not be construed as investment advice. Responsible investors should in every case perform their own due diligence on potential investments.*

# Cash and Cash Equivalents

## I. Introduction

As one of the most basic and secure of asset classes, cash typically consists primarily of liquid (or nearly liquid) interest-bearing instruments, such as deposits held at banks, credit unions, or other financial institutions.

Although cash alternatives are not generally high-return investments, they are often insured. For such deposits, individual or institutional investors bear little risk relative to the security of their capital or its expected returns: As regulated institutions, banks are subject to safety and soundness oversight and are required to submit financial statement information at regular intervals. These deposits provide the backbone of the activities of financial institutions by providing the pool of capital these institutions use to underwrite other activities.

In this chapter, we examine responsible investment issues as they relate to the full range of financial institutions with which cash can be invested—from the largest global banks to small, specialized banks and credit unions to specialized loan funds making microcredit available to the poor. (We do not cover the related fields of making specialized community development loan funds, general community development loans, or microcredit available to the traditionally underserved.) Responsible investment practices can be applied across this full range of institutions.

## Cash and Responsible Investing

Cash, as an asset class, provides the greatest flexibility and widest range of opportunities available for responsible investors. Through cash investments, investors can support banks and credit unions whose lending practices integrate environmental, social, and governance (ESG) analysis into their business practices. For instance, cash deposits can:

- Support local, small sustainable business development
- Invest in low-income and affordable housing projects
- Promote access to appropriate capital for the economically underserved
- Provide small loans to individuals in developing countries
- Encourage financial education and other support for the underserved
- Implement credit and savings programs that combat predatory lending
- Support energy efficiency, alternative energy, organic farming, and fair trade programs

Considering social and environmental sustainability when choosing financial institutions with which to make cash deposits can add long-term value to this asset class without necessarily sacrificing market-rate returns. Here we analyze how

ESG factors can be incorporated into cash investments in two different sorts of financial institutions:

- **Small banks and credit unions** specializing in applying social and environmental considerations into all their financial transactions—sometimes known as community development financial institutions (CDFIs)
- **Large mainstream banks** aligning their operations with ESG considerations and offering specialized products to serve the underserved and enhance environmentally sound lending practices

Currently, a limited, but growing, network of small banks, credit unions, and loan funds exists through which responsible investors can make deposits or loans. Simultaneously, an increasing number of large, mainstream banks are publishing sustainability reports detailing their corporate social responsibility initiatives, identifying environmental banking opportunities, and initiating programs to serve historically underserved communities and support microfinance initiatives.

## II. Developing Responsible Cash Deposit Strategies

As noted, with cash alternatives, responsible investors can choose to focus on two aspects:

- How the financial institution’s business activities support the social and environmental priorities of the investor
- How the financial institution manages its own business so that it enhances its social and/or environmental performance

These considerations are not mutually exclusive, and investors may choose to focus on one or both when determining where to place their cash investments.

### **Strategy: Business Activities of the Financial Institution**

One crucial question is how can social and environmental returns be identified and distinguished from traditional banking practices? Responsible banking typically seeks to identify underserved communities and meet “unmet” needs. In particular, it often seeks to support those who have traditionally been excluded from the traditional world of finance because of either information gaps or biases in the market.

At the extremes, it is easy to distinguish a deposit in a credit union chartered to serve a low-income community from an off-shore tax shelter scheme for the rich. However, a considerable middle ground exists between these extremes. Responsible investors need to know (1) what defines a need as “unmet” and (2) how effective banks can be at addressing these unmet needs.

Some of the business activities financial institutions may emphasize to create positive ESG impacts and serve unmet needs include but are not limited to these areas:

- **Low-income and affordable housing:** Institutions may focus on providing appropriate financing to both homebuyers and affordable housing developers who may be otherwise excluded from mainstream housing markets.
- **Small business development in low-income communities:** Institutions can provide small business loans to individuals and more generally to economically disadvantaged communities that are often underserved by traditional banking practices, which tend to focus on larger size loans.
- **Fair lending practices:** Institutions can demonstrate their provision of credit products and services to individuals and communities without regard to race, ethnicity, or geography.
- **Innovative environmental projects:** Green banking seeks out innovative projects and opportunities in energy efficiency, alternative energy, organic farming, land preservation, and fair trade to assure that environmental progress is not held back through lack of funding for worthy projects.
- **Financial education, training, and starter accounts for those inexperienced with financial services:** Banks and credit unions can take initiatives to educate those who have little or no experience with checking or savings accounts, personal loans and credit, or the basics of personal finance to assure that all members of society have equal [or safe and sound] access to financial services.
- **Improved social services:** Some banking institutions have exceptional records of lending to community organizations providing child care, transitional housing, health care, food banks, homeless shelters, teen centers, and similar services that allow low-income communities to build the economic infrastructure that empowers residents.

**ShoreBank**, a pioneer in the United States responsible banking field, identifies underserved geographic targets through U.S. Census data, focusing on communities in cities such as Chicago, Detroit, and Cleveland with income and housing values below their state or regional median. For its environmental banking practices, **ShoreBank** reports on lending for projects that rehabilitate environmentally damaged land, that create energy-efficient buildings, or that reduce waste or toxic material use in business practices.

**Triodos Bank**, in the Netherlands and England, has, as its mission, the “financing of companies that add cultural value and benefit people and the environment, with the support of lenders and investors who want to encourage the development of socially responsible and innovative businesses.” It focuses on lending that supports double- and triple-bottom line investing.

David Porteous and Saurabh Narain of the **National Community Investment Fund**, a pooled fund that invests in community development banks, thrifts, and credit unions, have proposed a systematic measurement of community development bank impacts based on a bank’s “Development Lending Intensity” and “Development Deposit Intensity.” Their paper, “Social Performance Measurement for CDFI Banks,” is posted at [www.ncif.org](http://www.ncif.org).

More generally, Jed Emerson, a leading proponent of measuring investments by their “blended” financial, social, and environmental value has collected on his website, [www.blendedvalue.org](http://www.blendedvalue.org), a series of articles and examples of investments that analyze returns from a financial, social, and environmental perspective.

## **Strategy: Management Practices of the Financial Institution**

A closely related question is how do financial institutions integrate ESG concerns into the way they do business?

As a consumer of banking services, responsible cash investors have the opportunity to consider the most competitive provider of those services in terms of ESG attributes. Investors can examine the ways that the financial institution directs its business to meet ESG risks and opportunities and can also determine how the institution performs relative to its peers.

Careful assessments can help direct capital toward those financial institutions that excel in socially and/or environmentally responsible business practices. Some banks may have developed their own employee training and development programs, enhanced hiring from underserved geographies and communities, made a commitment to environmentally sensitive business practices, or established other business management systems that demonstrate the values that investors seek in their other investments.

Investors may also choose banks whose management and ownership consist primarily of women and minorities, and so, support the expansion and diversity of the banking community itself.

Key features of the financial institution's internal social and environmental performance include but are not limited to

- **Employment practices that are fair, equitable, and diverse;**
- **Diversity in management, ownership, and representation on the board of trustees;**
- **Appropriate incentives to encourage responsible lending and banking practices;**
- **Strategies to reduce its environmental footprint and the negative externalities associated with its operations;**
- **Responsiveness to broader issues associated with the financial sector.**

This might include such issues as the protection of individual privacy; the reduction of financial fraud, corruption (where appropriate), and predatory practices; or [the] development of social and/or environmental lending criteria.

**Wainwright Bank**, a Boston-based bank that offers traditional banking products, includes in its mission commitments to diversity, affordable housing, community development, and women's rights and gay and lesbian issues. These commitments are reflected in Wainwright Bank's internal policies (such as employment practices) as well as in its targeted efforts in saving and lending money.

### III. Opportunities for Responsible Cash Investment

In this section, we give a brief overview of some key vehicles that exist to permit responsible cash investment, especially through CDFIs and mainstream financial institutions.

#### **Community Development Finance Institutions (CDFIs)**

Community Development Finance Institutions are financing entities in the United States—banks, credit unions, loan funds, venture funds, and microenterprise funds—that are entitled to special federal grants on the condition that they direct a certain percentage of their capital and business to serving those who have historically lacked access to the financial markets. A number of CDFIs, banks, and credit unions are regulated, insured depositories that can offer investors risk-free investment opportunities, including certificates of deposits, savings accounts, and money market funds.

#### **Community Development Banks**

Typically small- and mid-sized banks operating in a high-fixed-cost industry and focused in low-income urban and rural markets that larger banks find difficult to serve, CDFI banks generally demonstrate an impressive ability to provide affordable loans to the full range of local household, small business, and nonprofit borrowers with repayment rates well in line with large bank peers. This success is based on in-depth market knowledge that informs customized market outreach and lending strategies as well as risk management protocols.

**The Community Development Finance Institutions Fund**, a federal agency within the U.S. Department of Treasury, was created in [1995] from a model that emerged with the work of **ShoreBank** in the early 1970s, when that Chicago institution set out to demonstrate that a commercial bank could be a catalyst for revitalizing blighted inner-city communities. This model has since then been replicated by more than 60 other community development banks, credit unions, and other financial institutions around the United States with CDFI certification, many of which are represented by the **Community Development Bankers' Association**.

Community development banks focus on underserved communities, and use local knowledge to overcome information gaps and biases in the market. **Liberty Bank and Trust** has focused on providing products and services to the historically underserved African-American community in New Orleans, and, as the bank has grown, to other parts of Louisiana and Mississippi as well.

Finally, a number of CDFIs are, like Liberty, minority-owned banks, and so, offer responsible investors the opportunity to support the diversity in the banking sector itself. For instance, **Carver Federal Savings Bank**, located in New York City, is a long-standing African- and Caribbean-American owned and operated bank that focuses its efforts on serving the African- and Caribbean-American communities in the city. The **Native American Bancorporation** is a Native-American owned bank that focuses its efforts on supporting economic development in Indian communities.

In the United States, CDFI banks have been pioneers in responsible banking. The generally strong performance of their loan portfolios demonstrates that, while the risk of lending in low-income communities—or to emerging sectors such as green banking—may be different, it is not necessarily greater than that in other markets. Through in-depth market knowledge, extensive community partnerships, and other support mechanisms (ranging from borrower training to government loan guarantees), the real and perceived risks can be effectively managed.

**The Community Investing Center** maintained by the U.S. Social Investment Forum houses a community investment database with basic data on several hundred community development financial institutions. The Forum, in conjunction with **Co-op America**, has made community investing a primary focus of its educational and promotional efforts. Its 1% or More in Community Campaign encourages money managers and mutual fund families to allocate one percent or more of their investments with community development financial institutions. Its goal is to grow the U.S. community investing industry to more than \$25 billion in assets in 2007. (It stood at \$5.4 billion in 2000 and \$19.6 billion in 2005.)

Insured investment in CDFI banks and credit unions can be regarded as “risk free” in the sense that they have explicit government backing. Furthermore, responsible investment is facilitated by the availability of CDFI certification and National Credit Union Association (NCUA; see below) “low income” designation, which offer established, standardized means for assessing community impact.

Holding a portfolio of cash investments with multiple, small financial institutions may increase transaction costs. Several substantial efforts—for one example, CDARS, see the adjacent box—are currently underway in the United States to address these issues, including efforts to pool funds to achieve scale and diversity of risk while maintaining a focus on community development. In any case, the costs of due diligence on insured cash deposits is relatively small compared with other asset classes.

**The Promontory Interfinancial Network** has developed its *Certificate of Deposit Account Registry Service*®. Also known as CDARS, this service allows an investor to make a single deposit of up to \$30 million with a participating community development bank or other financial institution and receive federal insurance, and single record keeping, on the full amount.

**Self-Help Credit Union**, based in North Carolina, provides loans to “women, minorities, low-wealth families, rural residents and nonprofit organizations.” *Self-Help reports annually on its loans for mortgages, small business loans, real estate development, and community facility financing, as well as performs traditional reporting on financial performance.* **Latino Community Credit Union**, also based in North Carolina, is one of the fastest growing community development credit unions in the nation, serving a diverse immigrant population.

Although Europe does not have an established Community Development Finance category for banking, some banks do focus their lending and saving practices on responsible investment.

Some banks in Europe are mainstream institutions that maintain a significant focus on lending or banking support with social and/or environmental benefit. **The Cooperative Bank** in Manchester, England, not only grew out of the cooperative movement, but has had exceptional efforts promoting ethical consuming and community economic development. **Charity Bank** in England is devoted to serving charitable organizations. **Dexia**, headquartered in Brussels, has a strong commitment to serving municipalities and other public entities and an equally strong commitment to achieving sustainability.

## Community Development Credit Unions

During the 1960s, in the United States, credit unions became one focus of those interested in addressing persistent poverty in urban neighborhoods and rural regions. Because credit unions are chartered to serve, and indeed are owned by members located in particular regions or are employees of certain firms, they are particularly well-suited for targeted economic development programs. In addition, credit unions have taken a lead in outreach to the unbanked, including the provision of emergency loans, used car loans needed for transit to work, microloans for small businesses, and appropriate mortgages for unconventional homeowners, such as those in manufactured housing or with

unconventional documentation.

“Low-income credit unions,” designated by the U.S. National Credit Union Administration (NCUA), are specifically designed to provide lending and saving vehicles for underserved communities or geographies and receive dispensation for non-member deposits, among other benefits.

A more focused network of over 250 community development credit unions has also developed in the United States, many of which operate under the umbrella of the National Federation of Community Development Credit Unions. While the credit union sector is not currently part of the CDARS network, the Federation of Community Development Credit Unions offers a nominee deposit program that assists investors in placing insured deposits throughout its U.S. credit union network. There are currently over 1,000 of these institutions in communities across the nation.

## **Mainstream Banks**

Responsible investors who choose to bank with traditional financial institutions may seek those that exceed regulatory expectations to support underserved populations. In the United States, the Community Reinvestment Act (CRA), which was passed to ensure that banks serve all income segments in their geographic areas, has proven crucial to encouraging the development of responsible banking practices in the mainstream. Mainstream banks may offer products and services targeted to low- and moderate-income geographies and communities, in addition to their traditional lending activities, or may support environmentally sensitive lending. All U.S. banks are required to make public their CRA performance evaluations. These evaluations can help responsible investors assess the degree to which any bank works to serve the low-income communities and residents of its market area.

Investors may also wish to engage directly with banks. In several cases in the United States, mission-based institutional investors have negotiated deposits with banks on the condition that they maintain or locate branches in underserved neighborhoods. These so-called “linked deposits” may also support specific lending initiatives of interest to the investor.

Increasingly, large commercial banks have also turned to targeted investment products, such as microloans, that support entrepreneurial activity in communities—both in developed and emerging markets—that have been traditionally neglected by the financial services industry. Microloans are often targeted to women who may not have access to other forms of credit.

Similarly, as environmental issues have received increased attention in recent years, more banks are incorporating environmental criteria in loan decisions for a variety of reasons. For example, large banks such as Citigroup and Bank of America have in 2007 announced multi-billion dollar projects related to green lending for environmentally sensitive construction or other “green” activities, with many other mainstream banks also supporting similar opportunities.

*In 2002, the **International Finance Corporation** put forward the Equator Principles to identify social and environmental guidelines for project finance. Many major financial institutions have signed the voluntary principles; in addition to their role in defining principles, they offer a standard for bank clients by which to judge bank practices.*

Finally, responsible investors can look to an institution’s espoused principles in banking and lending, and its public commitment to voluntary codes of conduct that focus on social and/or environmental issues. A key factor here may be the financial institution’s willingness to report on its practices via social reporting frameworks or other mechanisms.

Responsible investors may wish to use their cash deposits as a means to engage their banks, by requesting information about responsible investment programs, and by encouraging banks to evaluate their own performance in social and environmental areas of concern. By raising awareness that the bank’s consumers do consider the institution’s social and/or environmental performance when making their decision, responsible cash investors are able to create an additional incentive for these institutions to become leaders in these areas.

# Fixed-Income:

## **Key Opportunities for ESG Analysis and Impact:**

- Enhanced risk analysis
- Investment in underserved communities
- Support public goods and infrastructure
- Align investments with mission

## **Key Tools for Measurement and Engagement:**

- Request ESG information
- Advocate for targeted investment products
- Engage corporations and governments on ESG issues
- Incorporate ESG factors into RFPs

## **Key Investment Product Types:**

- Targeted community development bond funds
- Separately managed portfolios
- Screened portfolios of government bonds
- Screened portfolios of corporate bonds
- Bond funds constructed with rigorous ESG criteria

## **Potential Benchmarks:**

Market-rates of return are typically determined by comparison to standard industry benchmarks. For Fixed-Income Investments, potential benchmarks might be, for instance, the Lehman Brothers Aggregate Bond Index or the Lehman Euro-Aggregate.

*Note: Investment products and organizations mentioned in this chapter are for illustrative purposes only, and should not be construed as investment advice. Responsible investors should in every case perform their own due diligence on potential investments.*

## I. Introduction

Fixed-income consists of bonds and other short- and long-term, fixed-return debt instruments issued by a wide range of institutions, including national and local governments, quasi-governmental bodies, public and private corporations, and large nonprofit organizations.

Fixed-income has been generally regarded as one of the safer, more conservative investment opportunities and has served as a core holding for many institutional investors and wealthy investors. Many bonds are issued to finance specific government projects, such as infrastructure building, and thus have clearly identifiable social purposes. Other bonds fund the general activities of governments and are more generally tied to the creation of public goods, including education, security, legal systems, and pure scientific research.

In recent decades, the financial community has developed a large and sometimes bewildering array of fixed-income products, including collateralized debt securities and derivatives.

In this chapter, we focus primarily on the strategies for assessing the social and environmental impacts of traditional fixed-income securities such as bonds. This limited approach does not cover the full range of fixed-income products, but rather touches on the primary ways in which sustainability issues can be integrated into investments in this asset class.

### Fixed-Income and Responsible Investing

Environmental, social, and governance (ESG) analysis has the potential to enhance fixed-income analysis. As an asset class, fixed income is issued in large part by governments to fund public services and by large corporations to fund expansion projects. This offers unique opportunities for responsible investors to participate in the creation of public goods, infrastructure, and long-term corporate assets, and as a result may:

- Create low-income and affordable housing
- Support business development in low-income communities
- Fund innovative environmental projects
- Provide public goods to underserved regions
- Improve public and private infrastructure

In this chapter, we explore how ESG factors can be incorporated into the following three types of fixed-income financial instruments:

- **Debt or securitized debt instruments supporting community development**, such as affordable housing and small business development
- **Debt instruments issued by governments for infrastructure projects and for the creation of public goods** (education, roads, health care, safety) in economically underserved regions
- **Debt instruments issued by corporations having strong social and environmental profiles**

Historically, relatively little attention has been given to ESG factors in fixed-income investing. However, a small, but increasing, number of funds are now being offered that focus on such factors as the community development goals of fixed-income securities, the sustainability records of corporate debt, and the human rights and development records of nations issuing sovereign debt.

## II. Developing Responsible Fixed-Income Strategies

Responsible investment in fixed-income options requires an analysis of the ESG profile of investments to better understand their financial risks and opportunities and also to fully understand the collateral benefits or harms that they may create for society at large.

As with any asset class, the key to this process is the gathering and weighting of information to determine acceptable and exceptional levels of social and/or environmental impact. Investors should also note that the relative liquidity of responsible fixed-income investments is a crucial financial consideration.

Investors seeking to incorporate ESG information into their fixed-income mandate can consider the possible long-term positive spillover effects or, alternatively, the long-term ESG risks implicit in various investment opportunities.

### **Strategy: Focus on Risk and Opportunity via ESG Analysis**

Fixed-income investment offers investors the opportunity to reduce their investment in or reject practices that they believe create long-term financial risks or destroy long-term value for society at large. Responsible investment may enhance the analysis of risks and opportunities—in particular bond offerings—by enhancing the analysis of long-term such as:

- Governance risk
- Corporate reputation
- Governance risk
- Political risk
- Litigation risk

In each of these cases, poor governance or changes in the way that societies and governments treat important social and environmental challenges can potentially impact corporate performance. ESG analysis may help build on traditional evaluation of credit risk to determine the future prospects of default. This can take place on a company-specific basis, but also can apply to industry-wide trends that relate to issues such as climate risk.

It should be noted that ratings agencies play a fundamental role in determining the credit risk of bonds—and perhaps the crucial role for institutional investors. To date, ratings agencies have not integrated ESG analysis into their standard practice; and so responsible investors have the opportunity to supplement these agencies' analysis with either their own or others' ESG research.

*UK-based Insight Investment focuses on integrating ESG analysis into credit risk, using ESG information to identify potential “landmines” that may increase a company’s chance of default.*

Finally, mission-based investors in particular may wish to underweight or reject government or corporate debt offerings that support activities that these investors feel destroys long-term wealth in society, or that do not correspond to the particular investors' stated values. Screened fixed-income portfolios, like the screened public equity portfolios described in Chapter Three, offer mission-based investors the opportunity to avoid contradictions between mission and investment policy.

### **Strategy: Focus on Identifying Practices to Support**

Bonds can offer responsible investors a relatively direct relationship with the ESG profile of their investment in ways that can provide tangible impact. Fixed-income investments can support the creation of public goods that, apart from their immediate return to investors, generally enhance sustainable economic growth. As with cash deposits, impacts may include but are not limited to support for:

- **Low-income and affordable housing.** Bonds can provide capital for the provision of financing to those who may be otherwise excluded from mainstream housing markets.
- **Business development in low-income communities.** Bonds can provide capital to entrepreneurs who are otherwise ignored by traditional banking practices.
- **Innovative environmental projects.** Bonds can target innovative public and private projects in energy efficiency, alternative energy production, organic farming, land preservation, and fair trade to assure that environmental progress is not held back through lack of funding for worthy projects.
- **Improved provision of public goods.** Bonds can support public and private (nonprofit or commercial) initiatives that provide key public goods such as childcare, transitional housing, healthcare, food banks, homeless shelters, teen centers, and similar services to assure that underserved communities have an infrastructure that empowers their members.
- **Improved public infrastructure.** Bonds can support socially and environmentally sound projects, whether public or private, that create needed infrastructure to support economic growth in a responsible manner. These may include bonds that support education, public transportation, railways, improved roads or bridges, clean water, environmental clean-up, or other infrastructure works that investors believe serve the public good.

### **Strategy: Negotiate Terms That Include ESG Criteria**

Large institutional investors may issue Requests for Proposals (RFPs) for fixed-income asset managers that incorporate ESG criteria as part of their investment mandate. If responsible investors purchase bonds directly, they also have the opportunity to negotiate specific terms that may include ESG criteria in the underwriting language of the bond itself.

If, as is more often the case, bonds are purchased through intermediary institutions, responsible investors should clearly identify how that intermediary identifies, measures, and reports in the criteria that undergird the ESG analysis of their fixed-income products. Engagement between asset owners and fund managers on responsible investment topics is, as with every asset class, fundamental to the successful incorporation of responsible investment tools into the investment process.

### III. Opportunities for Fixed-Income Investment

We can distinguish among three forms of fixed-income investment that lend themselves to responsible investment practices: (1) targeted investment (in communities or geographies that have lacked access to capital), (2) government debt, and (3) corporate debt.

#### Community-Development Targeted Investments

Fixed-income products offer the potential for investors to find new debt markets in undeserved communities, and in the process, support economic activity that brings collateral social and/or environmental benefits. This activity has tended to fall under the heading of community development investing or “targeted investment,” where loans, or pools of loans, are sold to investors based on their specific social and environmental profiles.

Typical in this regard are pools of asset-backed securities to support small business activity or mortgage-backed securities that support the purchase of homes by lower income residents. Government agencies, such as the U.S. Small Business Administration (SBA) or the Federal National Mortgage Association (Fannie Mae), may offer infrastructural support or other forms of subsidy for this activity. For instance, in the United States, the SBA has worked with investors to create securitized pools of loans to low-income and minority-owned businesses.

Targeted fixed-income investments may be issued by government agencies themselves, or by investment intermediaries that use specific social, environmental, and economic criteria to create investment products that produce positive spillover effects. They may include both specialized bond funds created through specific ESG criteria; they may also include special accounts that investors create through their own ESG mandates with fund managers.

*In the United States, **Access Capital Strategies**, a Boston-based firm, has created a targeted investment that offers investors market-rate returns from pooled debt that supports lower income homebuyers, small businesses, and community development projects. Similarly, the Florida-based **Community Capital Management** targets affordable home buying as well as environmentally beneficial infrastructure, job creation, and affordable health care. Each of these intermediaries reports to investors geographically targeted information on collateral social benefits as well as environmental performance. Each also offers investors the opportunity to create separate accounts tailored to their specific goals.*

Key to these targeted investments will be a system to measure their social and environmental profile. As in banking, for many targeted investment products, measurement will likely include these types of data:

- The number and income of people served via the bonds issued
- The economic and social profile of geographic areas and communities served
- The nature of economic activity supported by the bonds, as measured by the numbers of jobs created, affordable homes or home purchases supported, community centers created, etc.
- The percentage of a bond fund or other product that is targeted to communities or geographies in need
- The participation and/or evaluation of local community groups, NGOs, regulatory agencies, or other organizations well-suited to evaluate the real life impact of economic activity supported by investments

Some information—such as impact reports for first-time, low-income homebuyers in the United States—contains detailed socioeconomic profiles of the ultimate source of income for the bonds. For other types of information, investors instead are likely to rely on rules-of-thumb to gauge impact.

Nevertheless, investors may wish to use these rough categories of measurement to differentiate the ESG impact of the bonds they purchase—fixed-income products targeted at lower income people or at communities damaged by natural disasters or hard-hit by economic downturns, or bonds that directly support community revitalization efforts that may have the greatest positive spillover effects.

Less targeted fixed-income products that support government agencies that are in part engaged in community investment, or that provide capital to a reduced percentage of communities or people in need, may be seen as having important social benefits without reaching the exceptional level supported by other products. A rough ranking of ESG costs and benefits may help investors spread risk across their portfolio in a manner that optimizes financial, social, and environmental value.

## Government Debt

Apart from those government bonds that specifically support community development, responsible investors can take a more general approach to government bonds that incorporate ESG information into the analysis.

Investors can also incorporate region- or country-wide ESG analysis into their investment analysis, as a way to mitigate risk and also engage governments on practices that create long-term economic, social, and environmental costs. Investors have screened countries on everything from corporate governance regulatory practices to environmental policies, to respect for human rights and international accords.

Investors can also seek those government bonds that support the creation of public goods, such as needed infrastructural improvements, support for schools, or the development of sustainable energy sources. In this case, the investor, or more likely, an investment intermediary, could purchase government debt targeted to a specific activity.

*Two European bond funds offer examples of responsible investment in government debt. The **Dexia Sustainable Bonds Fund** includes an examination of government support for human rights and democratic government in its investment criteria. The **Sarasin Sustainable Bond Fund** rates countries, as well as other bond-issuing entities, on their support for sustainable environmental practices, and weights its fund to support what it views as institutions with superior environmental performance.*

Government debt does not necessarily offer investors many opportunities for direct engagement, but clearly stated policies do offer the opportunity to engage

with government bodies on specific issues. While responsible investment may offer valuable opportunities for engagement tools to assess risk and opportunity, they naturally carry with them the risk of political controversy for investors themselves.

## Corporate Debt

Responsible investors can treat commercial bonds in much the same way they treat public equities. ESG analysis can help identify well-run companies that mitigate risk, effectively manage reputation, and are positioned to take advantage of opportunities created by changing social and environmental circumstances.

Corporate debt also offers particular opportunities to support corporations or other institutions that offer innovative solutions to important social and environmental challenges. Investors may choose to perform such analysis in-house, contract research into corporations from research services, or invest through intermediaries (often bond funds) that apply clear and consistent criteria in their portfolio construction.

Commercial bond funds can be constructed both to support economic activity in parts of the private sector that target sustainable business practices, or, alternatively, that exclude corporations involved in activities that investors believe conflict with their values.

*The **Morley Sustainable Corporate Bond Fund** identifies corporations with positive social and environmental profiles for inclusion and screens out other corporations for ethical reasons. The **PaxWorld High Yield Fund** seeks high yield (also known as non-investment grade or junk) corporate bonds that support businesses that contribute to quality of life through their products and services. The Fund also includes negative screens found in PaxWorld's other investment products.*

Funds can also be constructed to target specific sectors of the economy or particular social or economic problems that address responsible investment concerns. The issue of climate change, for instance, has led to the creation of fixed-income investment products that target corporations that are addressing risks and opportunities related to global warming.

**JPMorgan Chase and Innovest Strategic Value Advisors** recently released a climate change bond index that weights corporate bonds based on the issuing corporation's ability to address global warming solutions and to mitigate climate risk.

Finally, it should be noted that many investment intermediaries offer bond products that mix styles of responsible investment, and also blend community development, government, and commercial bonds together into a single investable product.

New York-based **Domini Social Investments** offers a bond fund that targets a range of social and environmental issues while maintaining a return consistent with traditional benchmarks. The **Domini Bond Fund** blends community development, government, and commercial bonds using a rating system that measures bonds on the depth of their positive social and environmental impact. The Fund allocates up to 10% of assets to CDFIs.

## Public Equities:

### **Key Opportunities for ESG Analysis and Impact:**

- Integration of ESG analysis in valuation
- Screening (standard-setting) on ESG performance
- Advocacy of enhanced corporate ESG performance (engagement)
- Alignment of investments with mission

### **Key Tools for Measurement and Engagement:**

- Request reporting of ESG data
- Identify ESG research institutions
- Incorporate ESG into investment mandates
- Vote on shareholder resolutions
- File shareholder resolutions
- Advocate for enhanced ESG standards

### **Key Investment Product Types:**

- ESG portfolio managers
- Screened Mutual Funds

### **Potential Benchmarks:**

Market-rates of return are typically determined by comparison to standard industry benchmarks. For Public Equities, potential benchmarks might be, for instance, the FTSE 100 Index, the S&P 500 Index, or the Russell 3000 Index.

*Note: Investment products and organizations mentioned in this chapter are for illustrative purposes only, and should not be construed as investment advice. Responsible investors should in every case perform their own due diligence on potential investments.*

## I. Introduction

The public equities market consists of the publicly traded stocks of large corporations. Generally operating through highly regulated and highly liquid stock exchanges, equities offer the prospects of higher returns than either cash or fixed-income, although with correspondingly higher risk and volatility. During the last half of the twentieth century, they became an investment vehicle used increasingly in the core portfolios of individual and institutional investors.

Equities represent ownership in corporations, and therefore, theoretically come with certain rights and opportunities for responsible investors to influence the management of these companies. In practice, however, because ownership of public equities is so broadly dispersed and highly liquid, the ability of stockowners to function directly as active owners is somewhat limited and rests primarily with large institutional or activist investors.

In this chapter, we focus on the resources available to responsible investors to integrate environmental, social, and governance (ESG) concerns into their public equities portfolios, including integrated ESG analysis, screening, and engagement techniques. These techniques are tools that have been developed by the socially responsible investment community over the past 40 years and are now increasingly used by mainstream investors.

### Public Equities and Responsible Investing

Incorporating ESG analysis into the ownership of public equities can add long-term value to this asset class without necessarily sacrificing market-rate returns. ESG factors can be incorporated into public equity investing in at least three different ways:

- **Integrated ESG analysis:** Enhancing traditional financial analysis by taking into account the long-term implications of material ESG risks and opportunities.
- **Screening:** Sometimes referred to as standard setting, this takes various forms including (1) negative screens or standards, (2) positive screens or standards, and (3) best-of-sector screens or standards. These practices are also known as triple-bottom line investing, sustainable investing, and ethical investing.
- **Active ownership:** Sometimes known as engagement, active ownership takes on various forms, including (1) proxy voting and shareholder resolutions addressing ESG issues, (2) direct engagement with management on ESG issues, and (3) public advocacy around ESG issues and transparency.

As an asset class, public equities constitute ownership in the largest corporations in the world and present unique opportunities for responsible investors to positively influence the interactions between these powerful economic forces and society. Engaging companies in dialogue on ESG issues may allow responsible investors to fulfill these goals, among others:

- Address the risks and opportunities associated with global climate change
- Implement thorough environmental management systems
- Improve vendor labor standards
- Invest in employee and labor relations
- Adopt work/family benefit programs
- Increase diversity in the workforce and on boards of directors
- Communicate more thoroughly with investors on issues of corporate social responsibility

Public equities and the corporate social responsibility records of the companies issuing these stocks have historically been the primary focus of responsible investors. This is the most developed segment of responsible investment to date, with trillions of dollars reportedly invested in public equities according to responsible investment principles around the world.

## **II. Developing Responsible Public Equity Investment Strategies**

The most commonly publicized approach to responsible public equity investment is to apply positive and negative screens, based on ESG concerns, during investment selection. In addition to screens, investors have developed sophisticated tools to integrate consideration of ESG issues into fundamental company analysis. For some investors, particularly those from mission-focused or faith-based organizations, some ESG concerns will exclude the possibility of investing in particular companies or industries. On the other hand, it is becoming increasingly apparent that there are additional insights that can be gained from recognizing the materiality of certain ESG issues and integrating this information into the process of financial analysis. The different approaches outlined in this section are: ESG analysis, positive and negative screens, and “best-in-sector” screens.

## Strategy: Integrating Environmental, Social, and Governance (ESG) Analysis

The growing recognition that ESG issues can be material to business is leading investors to develop a heightened sense of the importance of integrating management of key risks and opportunities in fundamental stock analysis. Research conducted by the UNEP Finance Initiative Asset Management Working Group has highlighted ways investors are using available information to assess companies' performance across key ESG performance indicators in order to determine whether there are material risks facing the business, risks not necessarily revealed through an analysis limited to the company's financial statements. Consequently, responsible investors may be able to gain an additional insight into the company's potential by recognizing that long-term ESG issues—such as climate change or obesity—are not currently priced into its share price.

**The United Nations Environment Program Finance Initiative Asset Management Working Group** has sponsored the publication of a “Materiality” series that examines the opportunities for sector-specific integration of ESG analysis into investment decision-making. In this series, large asset managers and consultants have emphasized the business case for sustainability analysis and have drawn attention to the opportunities for further research and action into the implementation of ESG investment frameworks.

A key feature of any assessment of ESG issues is the time horizon used by the investor. By properly recognizing the importance of certain ESG issues to the long-term performance of companies, investors are able to benefit as well as create incentives for managers to overcome the short-term pressure created by “market myopia.” This will lessen the pressure to create quarterly solutions to long-term problems. Investor may also wish to use their contracts with asset managers to emphasize long-term performance criteria that better align the interests of asset owners and managers.

**The Enhanced Analytics Initiative**, a collaboration of asset owners and managers representing approximately \$2.4 trillion in assets under management, seeks to create incentives for sell-side research into material extra-financial factors. The goal is to help build infrastructure and capacity in extra-financial analysis and to increase the use of material information on stock performance that, for a variety of structural reasons, may be overlooked in the current working of financial analysis.

**The Marathon Club**, a UK-based collaboration of investment organizations, has written a guidance paper that explores how trustees and asset managers can construct mutually aligned objectives that focus performance on long-term value creation.

### **Strategy: Focus on Screening Techniques**

Screening techniques, sometimes called standard-setting, differ from integrated ESG analysis, as they often result in the inclusion or elimination of companies from consideration for investment prior to traditional financial analysis. These screens are not necessarily negative (exclusionary) screens, although these are perhaps the best known part of the social investment world. Screens may also be used to emphasize investment in companies that are having positive ESG impacts or act as a proxy for good governance by identifying companies that are “best in sector” on the management of long-term risks to the company, including ESG risks.

### Performance Studies and Resources on Responsible Public Equity Investment:

*Over the past two decades, literally hundreds of academic articles have appeared studying the financial performance of socially screened mutual funds, indexes, and money managers. Their findings differ, but a meta-analysis of the literature by Marc Orlitzky, Frank Schmidt, and Sara Rynes published in 2003 found a positive correlation between corporate social performance and corporate financial performance. Other studies suggest no statistically significant difference between screened mutual funds and their unscreened counterparts, although the former had greater volatility.*

*The most comprehensive single source of studies on this issue may be found at [www.sristudies.org](http://www.sristudies.org).*

*Social Investment Forums around the world are the best starting point for more information about responsible investment in public equities. These trade associations survey the world of responsible investment regularly and provide background data on its recent development. These include **ASrIA** (for Asian social investment practices), **The Canadian Social Investment Organization**, **The Ethical Investment Association Australasia**, **EuroSIF**, **UK Social Investment Forum**, and **the U.S. Social Investment Forum**.*

*See also websites devoted to social investment mutual funds, such as [www.socialfunds.com](http://www.socialfunds.com) or [www.responsible-investor.com](http://www.responsible-investor.com).*

The key critique that is made of applying screens is that they narrow the universe of possible investments available, thereby exposing investors to increased risks. Screened investment products—and many other investment products as well—typically use optimization techniques to readjust the risk characteristics of their screened portfolios relative to a particular benchmark.

Research seems to suggest that funds to which ESG screens have been applied tend to perform no better and no worse over the long term than those for which no ESG screens are applied. Mission-driven investors will want to consider the financial and social implications of this research when making investment decisions.

Screening techniques can be characterized by (1) negative screens, (2) positive screens, and (3) best-in-sector screens. When formulating these screens, responsible investors must take into account how their application will impact portfolio diversification and whether it is practical to apply the screens to all investments.

## Negative Screens

The most common use of negative screens is to eliminate particular industries from the range of possible investments. Some common negative screens include tobacco, gambling, nuclear (or other) arms production, and alcohol. In the United States, starting with the South Africa divestment movement of the 1970s and 1980s, negative screens also have been associated with divestment from corporations operating in countries whose governments are exceptionally oppressive. Negative screening offers the potential to remove from investment portfolios stocks that destroy long-term value through externalities, create heightened risk exposure because of social and/or environmental changes, or violate an investor's moral principles.

*There are a wide variety of screened investment products, including index funds based on both negative and positive screening techniques, religiously oriented funds that offer screens tailored to support particular doctrines, money managers who offer negative screens tailored to the values and concerns of individual investors, and negative screens meant to reduce financial risk.*

## Positive Screens

Positive screens are used to emphasize those industries that responsible investors believe are contributing solutions to ESG problems. Because ESG issues impact the long-term sustainability of companies and industries, positive screens can act as a proxy for sound, long-term management practices in a company. Examples of the sectors that are typically included in positive screens include healthcare providers, renewable energy production, recycling services, and pollution reduction.

**Henderson Global Investors Global Care Growth Fund** is invested according to a strict socially and environmentally driven mandate that incorporates positive and negative screens. The fund is invested exclusively according to Henderson’s “Ten industries of the future” theme, which includes cleaner energy, efficiency, environmental services, health, knowledge, quality of life, safety, social property and finance, sustainable transport, and water management. Once the companies have been selected, further criteria are applied to exclude particular areas of concern, including alcohol, armaments, irresponsible marketing, oppressive regimes, nuclear power, ozone-depleting chemicals, and pesticides.

**ClearBridge Advisors**, an affiliate of Legg Mason, has managed Socially Aware Investment (SAI) portfolios with applied ESG integration since the 1980’s. ClearBridge’s sustainability and fundamental research platform is utilized for stock selections that meet investment criteria for SAI portfolios, which incorporate the relevant weightings of ESG with a long-term view. ClearBridge’s SAI approach includes proxy voting, rigorous pro-active screening, and active engagement with companies and their managements.

## Performance-based or “Best-in-Sector” Screens

Performance-based or “best-in-sector” screens are similar to positive screens, but rather than focusing on industry sectors, an external performance indicator is used to identify companies that qualify as investable. These indicators should be based on the investor’s key ESG concerns and may be structured to include only those companies that perform to a certain level relative to their peers or relative to the external benchmark. For example, a company may be within this investable universe if its level of carbon reductions puts it in the top 10 percent of its industry, or if its carbon emissions are below a particular percentage over a given time.

*The **Innovest/F.B. Heron Foundation Community Investment Index** is a positively screened, best-of-class index for corporate engagement with underserved communities in the United States. Initial beta-testing results suggest that this index will provide a market rate of return with a relatively narrow tracking error.*

*The **Dow Jones Sustainability Index (DJSI)** and the **FTSE4Good Index** rank publicly listed companies according to a range of ESG information. For example, the DJSI applies a set of weighted criteria to 2,500 largest companies in the **Dow Jones Global Index**. These criteria provide a score for each company based on its sustainability performance. Companies are then ranked according to their performance on these ESG issues as a whole and in industry sectors. **KLD Research and Analytics** constructs several index funds—such as its **Broad Market Fund** or **Global Climate Index**—that integrate ESG information into investment decisions.*

Access to accurate and comparable information about a company's performance against the indicators selected is critical to the success of a "best-in-sector" screen. Therefore, investors must design indicators that are practical to apply. Although corporations are now reporting more information, ensuring comparability and accuracy is still an issue. If money managers or mutual funds do not want to develop their own in-house capabilities for researching ESG performance, several organizations provide specialized research services.

Some of the more established social and environmental research service providers include **EIRIS** (UK); **GES Services** (Sweden); **Innovest** (international); **Institutional Shareholder Services** (international); **KLD Research and Analytics** (U.S.); **Michael Jantzi Research Associates** (Canada); **SAM Group** (Switzerland) and **SiRi Company** (Switzerland); **SIRIS** (Australia); and **Vigeo** (France).

### III. Opportunities for Responsible Public Equity Investment

After an investment has been made, responsible investors have further opportunities to ensure that the way they act as share owners also aligns with their ESG concerns. As shareholders, public equity investors have the right to participate in the governance of the companies in which they have invested, which in turn allows them to engage in active ownership and engagement with management. In addition to direct communication with companies, investors can have significant influence over managers through public advocacy on ESG issues. They can also support greater transparency on ESG performance by companies as a means of implementing the strategies set out in this chapter.

#### Active Ownership

**The Carbon Disclosure Project (CDP)** was founded in December 2000 and is the world's largest investor coalition representing 280 institutional investors with assets of \$41 trillion. The purpose of the CDP is to increase disclosure of Greenhouse Gas (GHG) emissions and to encourage public companies to reduce their emissions. Each year, CDP sends a survey to the largest global companies (in 2007 to 2,400) on behalf of the CDP members, which requests that companies disclose their GHG emissions.

As a shareholder, investors in public companies are entitled to participate in the governance of the company both formally and informally. These mechanisms can be used to raise awareness of the risks and opportunities that ESG issues pose to companies. They also allow shareholders to find out what companies are doing to address these issues. There has been a substantial increase in the means and volume of engagement strategies among both the mainstream and responsible investment communities in recent years. This is driven in part by the recognition among an increasing number of shareholders who believe that responsible engagement with companies can improve the company, and consequently investment performance. For institutional investors with few divestment opportunities, engagement can be the single best way to promote change on specific ESG issues within individual firms.

Responsible investors can engage with corporate management on ESG issues by:

- **Voting as a shareholder:** Depending on the applicable law and the company's constitution, many issues, particularly those related to governance of the company, must be put to shareholders for approval. By actively participating in these shareholder votes, investors are able to better ensure that the interests of management are aligned with those of shareholders and that incentives are in place to ensure that proper account is taken of social and environmental issues.

**The Interfaith Center on Corporate Responsibility** is a coalition of faith-based institutional investors that helps coordinate the filing of over 200 shareholder resolutions in the United States each year.

- **Filing shareholder resolutions:** Even though some issues fall outside of the mandatory voting requirements, shareholders may also be entitled to propose their own resolutions. Elevating ESG issues to the level of a shareholder vote raises awareness of the issue to senior management, the board, and other investors. Framed correctly, these resolutions can result in important changes to corporate policy. Many resolutions focus specifically on increasing the available information on ESG issues that responsible investors need to properly assess the risks and opportunities facing companies. Supporting greater transparency and accountability from a shareholder position is a powerful tool for improving corporations' ESG performance.

Responsible investors should consult with their investment managers to ensure that their shares are voted on at company meetings. Responsible investors should also be aware that, by entering into stock lending arrangements, they may be forgoing opportunities to participate in shareholder votes. In some cases, this may result in shares being voted in a manner contrary to the ultimate owner's interests—for example, where a hedge fund manager with a short position has borrowed shares to support a particular event.

**ISS Global Proxy Services** and **Glass Lewis** both analyze proxies and provide recommendations about voting decisions to institutional investors based on a corporate governance assessment of the decision, as does the UK-based **Pension and Investments Research Consultants (PIRC)**. By increasing their participation in proxy votes, shareholders are able to better play their role of monitoring corporate managers.

A good overview source for information on corporate governance issues is **Global Proxy Watch**, a newsletter published by the Connecticut-based **Davis Global Advisors**.

## Direct Engagement with Management on ESG Issues

Investors and shareholders are often provided opportunities to engage directly with senior management and investor relations officials to raise key concerns or explore issues of corporate performance and strategy in more detail. These sessions present a unique opportunity to highlight the importance of ESG issues both to management and to other investors. By ensuring that their investment managers are making sure that questions related to ESG management are firmly planted on the agenda at these meetings, responsible investors are able to raise awareness of the materiality of many of these risks and gain more mainstream support for better management of them.

Some ESG issues may be better discussed on an individual basis with company representatives. Particularly where change is sought on an important issue that deserves a more nuanced discussion, engaging with the company outside of a public forum can help facilitate a collaborative approach to resolving the issue. Companies may particularly heed the opinions of large or influential investors or coalitions, especially if this avoids a more public confrontation over the issue through the filing of a shareholder resolution.

Responsible investors should develop guidelines for proxy voting and ensure that investment managers are aware of these standards. Such standards may include:

- Requirements to actively vote shares on all or particular issues;
- Policies on certain governance issues; for example, director independence, disclosure, or executive pay that can be applied consistently across the portfolio;
- Ensuring that information about resolutions related to ESG issues is provided to the responsible investor for consideration and instructions on voting.

### **Public Advocacy Around ESG Issues and Transparency**

Shareholders can play a key role in advocating for changes that improve the way that companies manage ESG issues that impact on society at large. By raising awareness of the risks and opportunities that ESG issues pose to the investment community, responsible investors can promote changes in regulatory structure as well as business practice. Not only do responsible investors have a powerful voice, but through engagement, they can also provide insight into how corporations are most effectively managing ESG issues. Where appropriate, advocacy may be part of a shareholder coalition or take place through multi-stakeholder initiatives.

It is of course inappropriate for money managers or mutual funds to use their investors' assets to advance their personal political views. However, it is appropriate for responsible investors to initiate and participate in debates on issues that relate to the corporate role in society, to the extent that these roles have financial implications for the corporations themselves or to the economies in which they operate.

**The Global Reporting Initiative (GRI)**, founded in 1998, has pioneered efforts to create multi-stakeholder supported enhanced reporting criteria for ESG information—most recently in the introduction of a third generation of voluntary reporting guidelines. Regulatory bodies across the globe have also begun to address guidelines for reporting on material issues related to ESG performance.

A fundamental issue that directly impacts responsible investors' ability to apply ESG issues to their investment decision making—whether through ESG analysis or screening—is to ensure access to reliable, comparable, and accurate information. Despite the absence of formal requirements, the number of companies that report on ESG issues is steadily increasing. As well, these reports are becoming more standardized through projects such as the Global Reporting Initiative (GRI). The process of reporting not only benefits shareholders, but also means that companies are more aware of the ESG risks and opportunities that they are facing.

# Private Equity:

## **Key Opportunities for ESG Analysis and Impact:**

- Development of sustainable products and services
- Targeted investments in underserved communities
- Integration of ESG performance management.
- Diversity in ownership and management

## **Key Tools for ESG Measurement and Engagement:**

- Identify key ESG performance indicators
- Request ESG information
- Integrate ESG into technical assistance
- Incorporate ESG criteria into RFPs

## **Key Investment Product Types:**

- Social venture capital funds
- Cleantech venture capital funds
- Targeted “double-bottom” line PE funds
- PE funds with ESG programs

## **Potential Benchmarks:**

Market-rates of return are typically determined by comparison to standard industry benchmarks. Private Equity investments are notoriously hard to benchmark; potential benchmarks might be, for instance, the Venture Economics' US Private Equity Performance Index or their European Private Equity Performance Index.

*Note: Investment products and organizations mentioned in this chapter are for illustrative purposes only, and should not be construed as investment advice. Responsible investors should in every case perform their own due diligence on potential investments.*

# Private Equity

## I. Introduction

Private equity consists of investments in unlisted companies and ranges from venture capital investments in start-ups, to mezzanine financing for established companies aiming for a trade sale or public listing, to buy-outs of public companies. Private equity investments are generally only available to institutional investors, venture capitalists, and high-net-worth individuals.

There are many challenges associated with private equity investment, including information asymmetries, high risk and uncertainty, and the absence of a liquid market for shares. Private equity can offer high potential returns for this risk; and private equity managers often charge hefty fees for their services. Private equity investors tend to hold substantial ownership positions in corporations, and thus have substantial opportunities for direct influence on these investments.

In this chapter, we focus on responsible investment issues as they relate to private equity investments in funds or “funds of funds,” which allow for greater diversification of risk than direct company-by-company private equity investments. Opportunities for private equity investments in real estate are addressed separately in the real estate chapter of this *Handbook*.

### Private Equity and Responsible Investing

Private equity often represents a controlling interest in businesses and industries in their formative, growth, or turnaround phases. Considering environmental, social, and governance (ESG) factors in private equity investments can add long-term value to this asset class without necessarily sacrificing market-rate returns.

These ESG factors can play themselves out in three different private-equity approaches:

- **Product-focused investments** that set out to create businesses with social and environmental missions—sometimes known as social venture capital
- **Process-focused investments** that use large ownership positions to direct management to incorporate ESG factors into the culture of a company
- **Economically targeted investments (ETIs)** that often use public/private partnerships to create businesses, jobs, and housing in underserved communities

Private equity also offers unique opportunities for responsible investors to actively participate in and influence the creation of companies. These investors can

- Directly influence management to incorporate ESG initiatives into their businesses as they grow
- Encourage entrepreneurs to focus on developing businesses with high-impact social and/or environmental missions
- Direct capital to entrepreneurs in regions and communities that are underserved
- Promote the creation of local businesses and jobs

To date, responsible investment in the private equity sector has concentrated primarily in the development of a network of social venture capital organizations available to high-net-worth individuals and various ETI programs implemented by pension funds at a local level. Both social venture capital and ETIs have been around in various forms since the 1980s and have an increasingly well-established track record. In the United States, for instance, organizations such as Investor’s Circle and the Social Venture Network have helped focus attention on innovative, socially-oriented venture capital opportunities.

## II. Developing Responsible Private Equity Strategies

The tools for responsible private equity investment follow the general principles for responsible investing—investors must gather ESG information about their investments, create or purchase systemic means for integrating that information with financial analysis, and create standards for determining acceptable and exceptional performance.

### **Strategy: Building a Responsible Private Equity Investment Pipeline**

Private equity investments, by their nature, are future oriented, and investors depend on a solid pipeline of investable products to generate returns. The responsible private equity investor may pay similar attention to developing a pipeline of investments that generate social and environmental benefits and/or mitigate against social and environmental harm.

Large investors have the potential to craft requests for proposals (RFPs) that clearly state the form of social and environmental benefits under consideration. Such RFPs may:

- Identify the categories of products (clean tech, social service, biotechnology, etc.) that will receive consideration

- Delineate the ESG systems and policies that will bring a potential investment under consideration
- Elaborate the criteria—definition of low- to moderate-income geography, or standard measuring environmental impact—for economic targeting

By releasing RFPs of this type, institutional investors have the ability to set the terms of debate as to what constitutes responsible investments. Furthermore, institutional investors adopting a responsible investment strategy can play a role in creating a pipeline by making capital available for those companies that do take account of ESG—whether through their products, processes, or area of operations.

*A few large U.S. state funds have been active in soliciting targeted investments in private equity. In 2004, the **California Public Employees Retirement System (CalPERS)** and the **California State Teachers Retirement System (CalSTRS)** instituted a \$500 million investment in clean technology venture investing—part of the Green Wave program—that addressed crucial environmental problems surrounding climate change. The **Massachusetts Pension Reserve Investment Management (MassPRIM)** has created an RFP system for targeted investments that combines a close review of potential financial performance with a rigorous review of economic targeting criteria around spillover community revitalization benefits.*

Many, if not most, investors will invest indirectly through private equity funds, or “funds of funds,” in order to better mitigate their risks and properly diversify their portfolios. In this case, responsible investors will have less chance to directly affect the nature of pipeline development, but similar questions apply. Responsible investors should determine

- **The methods and procedures** that fund managers use to identify the potential social and environmental benefits of target investments;
- **The track record** of funds to deliver these benefits at market rates of return;
- **The information** the fund manager provides to permit assessment of the ESG impacts achieved by the fund.

In the case of both direct and indirect investment, the balance of financial, social, and environmental considerations is necessarily complex.

## **Strategy: Analysis of ESG Governance Systems**

Linked to the question of pipeline development is the general question about the accessibility of information about the ESG performance of private companies. Financial reporting requirements for private companies are considerably less onerous than those for listed companies, creating particular challenges for responsible private equity investors. There may also be less pressure brought to bear on private companies by external stakeholders and other shareholders. This means, in general, that there is less information available about ESG impacts. As in other asset classes, responsible investors can take the lead in demanding greater transparency on social and environmental performance from private companies.

A more active role by private equity fund managers provides an opportunity to monitor ESG performance from an insider position—for example, a board seat. This insider position can provide a counterbalance to the less robust reporting requirements applicable to private companies, and investors can request that either the company’s managers or their fund managers prepare a summary of ESG impacts across their portfolio companies. Reports may include:

- Technological innovations developed
- Number of jobs created
- Increases to employee benefits and improvements in working conditions
- Achievement of diversity goals in hiring and ownership in portfolio companies
- Carbon reduction, waste reduction, or other measures of environmental efficiency

*The **Bay Area Equity Fund** in San Francisco, managed by JP Morgan, targets venture stage businesses in or near low-to-moderate income (LMI) communities. The Fund works with management of portfolio companies to integrate double-bottom line programs into corporate practice, for instance through programs ensuring the potential to hire LMI residents.*

Formulating a clear process for assessing the ESG policies and procedures of both private equity funds and the companies they invest in is a vital step in the responsible investment due diligence process.

Communication between investors, fund managers, and the ultimate investees on financial, social, and environmental potential should be an integrated

process. Particularly for venture capital investments that are product-oriented, appropriate due diligence should include technical assessment of the impact of the social and environmental benefits provided by the product.

### **Strategy: Active Ownership**

As noted earlier, the relative concentration of ownership in private companies means that fund managers play a role that is often significant, if not controlling, of shareholders in their portfolio companies. This allows investors to influence business strategy as an insider. Consequently, active share-ownership can be an effective engagement tool for private equity investors.

Engagement may relate to the internal practices of the company, such as environmental management systems or improving employee benefits. For example, one approach may be to develop an action plan with existing management during the due diligence process. Integration of ESG analysis can be made a condition of financing and may even be formalized in the shareholders' agreement.

This plan may call for the fund manager to provide the specific technical expertise needed to create financial value, or, alternatively, ESG benefits. Investors in venture capital or development-stage funds can integrate these issues from an early stage in the company's growth, while investors in buy-out funds are able to build ESG considerations into the plan for restructuring the company.

Technical assistance is often provided to portfolio companies by private equity funds. Typically, technical assistance is focused on management team recruitment, strategy, and advice on seeking and restructuring additional debt or equity capital. Responsible investors may want to identify managers who also provide technical assistance for the management of ESG issues, for example, for workforce-related issues or environmental practices.

**SJF Ventures** is a venture capital fund that targets expansion-stage companies pursuing environmental or workforce innovation. During the due diligence process, SJF develops an action plan with each company to determine the workforce and/or environmental issues that SJF and the company agree to address. Technical support is then provided to portfolio companies to allow them to achieve these targets. By better managing ESG risks and integrating these steps into the portfolio companies' businesses, SJF is able to add value to the business, thus making the programs more sustainable.

### III. Opportunities for Responsible Private Equity Investing

This chapter sets out three types of impacts responsible investors may use when defining a private equity investment strategy—whether for the selection of fund managers or for directing their own individual investments. The approaches include (1) product focused investments, (2) economically targeted and “double-bottom line” investments, and (3) process-focused investments.

#### Product-Focused Investments

Venture capital (VC) and early-stage private equity investment is well suited to supporting the development of environmentally and socially beneficial products and services, for example, renewable energy, “cleantech,” or healthcare innovations. ESG analysis can help identify early-stage investments that create value by taking advantage of social and environmental change.

Venture capital makes capital available to companies that are researching or bringing to market new technologies and techniques. By targeting investment toward those areas that offer the greatest promise of positive social and environmental externalities, responsible investment can help determine the future direction of economic activity through the support of innovation.

Venture capital investments can be made either at “seed” stage (when the company is just beginning its work) or at a later stage (when the technology is closer to commercialization). Generally, later stage investment reduces risk, as the technology is more likely to be proven. Investing earlier can permit higher returns both financially and from an ESG perspective by creating an enabling environment for new ideas.

Many mainstream private equity investment products are now available in the technology area, creating much opportunity for investment. Most of these funds focus on the environment (particularly on renewable energy and “cleantech”). The United Nations Environment Program’s recent survey, *Global Trends in Sustainable Energy Investment 2007*, found that investment in renewable energy and energy-efficient technologies in 2006 increased by 43% to \$100 billion globally.

An advantage to taking a product focus, from a responsible investor’s perspective, is that the social and environmental benefit will endure regardless of the exit strategy. However, to achieve this benefit, the investor’s (and fund manager’s) team must include people with appropriate technical expertise to properly assess the prospects of the technology’s utility and likely success.

*The Cleantech Venture Network provides information and creates opportunities for investors seeking to identify opportunities in clean technology venture investment.*

**Emerald Technology Ventures** (formerly the private equity arm of **SAM Asset Management**) invests in technology-driven companies from the energy, materials, and water and nutrition sectors that are generating ways to optimize the use of natural resources while reducing environmental impact. A key part of the investment process is the technical assessment of the companies' technology in order to consider the viability of the social and environmental impacts.

When selecting fund managers, investors concerned with the ESG aspects of the products produced by the companies in the fund's portfolio should

- Clearly identify the type of product the investors want to focus on—for example, clean technologies, renewable energy, services that are directed to underserved groups or minorities, or solutions to healthcare problems
- Ensure that the fund manager has appropriate technical expertise to properly assess the potential of the technology to resolve the ESG issues identified as priorities
- Develop a mechanism for measuring impact—for example, the number of patents registered, products brought to market, or customers/patients assisted by the technology

## Economically Targeted and 'Double-Bottom Line' Investment

Private equity is an effective means of directing capital to new businesses and entrepreneurs and of reinvigorating underperforming public companies. By targeting the flow of capital to low- and moderate-income neighborhoods, companies owned and managed by women and minorities, or social entrepreneurs, responsible investors can create positive spillover effects in the form of jobs, stable tax bases, and a healthier economic and social climate. Directing capital to historically underserved communities by way of market rate of return investments ensures that the businesses supported are economically sustainable, building additional long-term value creation for the targeted areas or communities.

Focusing on the social and environmental impacts of these investments creates an opportunity for identifying unrecognized financial value through the explo-

ration of untapped markets. In recent years in the United States and United Kingdom, particular emphasis has been placed on urban investment that can support the economic revitalization of inner city and inner-ring suburban neighborhoods with underutilized workforces and capital stocks. In the United States, the Initiative for a Competitive Inner City, a nonprofit founded by Harvard Professor Michael Porter, has undertaken important work in defining the opportunities and complexities—both social and financial—for urban investment.

*The **Double Bottom Line Investment Handbook** highlights a series of U.S. regional economically targeted investment funds that provide market rates of return with spillover social and environmental benefits. These funds are characterized by public/private partnerships between investors, public officials, and community organizations, which combine local insight into market potential and community needs. According to the Handbook, these partnerships help identify investment opportunities and mitigate risk for investors.*

*The purpose of the **Small Business Administration's New Market Venture Capital (NMVC)** Program is to spur economic development in low income (LI) areas through equity investment. Operational assistance grants and tax incentives are offered to approved funds, with private investors who invest 80% of their capital and have 80% of their portfolio companies located in LI areas. There are currently seven funds approved by the SBA to participate in the NMVC program.*

These neighborhoods may be attractively situated, transit-oriented locations ready for redevelopment, but information asymmetry and market biases have prevented private equity funds from taking advantage of opportunities that exist for market-rate investments that have particularly beneficial side effects.

Pioneering work in targeted investment has focused on below-market rate investments supported by foundations and community development organizations through program related investments. There are also opportunities to invest in geographically or economically targeted funds that achieve competitive rates of return, and the U.S. government's Small Business Administration

(SBA) has programs that provide incentives for these investments.

Investments that are geographically targeted may or may not also take into account the product- or process-generated social and environmental impacts. In fact, responsible investors may consider that stimulating the local economy delivers sufficient social good.

While many government programs focus on small business development in underserved communities, there is also scope for economically targeted investment across the spectrum of private equity investment types—from VC to buy-outs. The key focus of investors should be the positive benefits delivered to these underserved regions through new employment opportunities, improved access to services, and improved business linkages. For those investors looking further afield, the same principles of targeted investment can be used to direct investment to countries where access to capital is hindering economic and social development.

When selecting a fund manager based on the targeted ESG impacts that can be achieved through the fund's investments, investors should:

- Identify the particular geographic region, historically underserved group, or economic area to which they want to make capital available
- Determine the type of impact that is desired, for example, encouraging new businesses and entrepreneurship or supporting businesses that create employment opportunities in the region (Alternatively, it may be appropriate to determine the target groups or areas based on program-related objectives)
- Identify indicators that the fund manager will use to measure impact including job creation, minority management and hiring, quality of jobs created, products or services made available to underserved areas, etc.

## Process-Focused Investments

*As a relatively small (approximately \$26 million) special equities component in which multiple Calvert funds participate, the **Calvert Special Equities Program** focuses on companies that provide market-based solutions to social, environmental, and health problems. All the Fund's portfolio companies must operate in a manner that is consistent with Calvert's investment principles; the fund targets "companies run by visionary entrepreneurs who have identified profitable ways of addressing society's needs."*

The third strategy for responsible investment in private equity is to incorporate an assessment of the portfolio companies' management of social and environmental issues into the investment decision making process—in much the same way that ESG screens can be applied to public equity investment. Investors may choose to focus on those funds that invest in companies with better track records of environmental management, benefits provided to employees, and governance records.

Similarly, investors can choose to support private equity firms owned and/or managed by members of historically underserved groups. Several pension funds in the United States have adopted “emerging manager” mandates that direct a portion of funds to women and minority private equity managers, with the goal of expanding the people managing money in the asset class. Other initiatives have focused on funds that invest in minority- or women-owned and managed businesses to support the growth of a more diverse and robust marketplace.

**The National Association of Investment Companies (NAIC),** a U.S.-based industry association that supports the development of minority-owned and managed entrepreneurial activity, supports private investment activity, public policy support, and educational training for investment companies that target diverse businesses. Investors with particular interest in emerging managers often invest in NAIC-affiliated funds.

The private equity class offers investors unique opportunities to influence management and encourage the adoption of sound management of ESG issues by virtue of them being significant shareholders. Therefore, it may be appropriate to include among possible portfolio companies those businesses that show potential for integrating ESG issues into their corporate culture, even though they may not yet be managing these impacts well.

For companies at an early or growth stage of development, there is scope for integrating ESG performance into the workplace culture, as employee and management practices are less entrenched. Similarly, investors who are in the buy-out stage have the opportunity to integrate ESG management strategy as part of a broader overhaul of the company. However, care should be taken to ensure a positive relationship with management, and it may make sense to direct capital to those entrepreneurs who already acknowledge the importance of ESG issues.

**Actis Capital LLP** is a private equity firm that invests in emerging markets in Asia, Africa, and South America. Actis assesses the impacts of all new investments on environmental, health, safety, social, and business integrity aspects as an integral part of the investment appraisal process. New investments are given a risk rating on these issues to determine the appropriate levels of management and monitoring required. Investee companies are required to sign up to an undertaking that they will comply with these basic principles. Where necessary, Actis assists companies in raising their environmental and social performance standards to meet best practices.

Upon exit, sound ESG management issues may add value to the company. While exit typically means that the fund divests of its interest in the company, if ESG issues are entrenched in the company's value proposition, there is a greater possibility that the programs will be maintained by subsequent owners.

As with economically targeted investment, it should be noted that process-oriented investments apply across the range of private equity stages. Venture capital and seed money can support innovative approaches to social and environmental problems, mid-level and mezzanine financing can help such approaches grow to scale, and buy-outs of public companies may offer the potential to improve performance through the integration of ESG management systems into underperforming public companies.

When selecting a fund manager that focuses on process impacts, responsible investors may wish to:

- Determine the key ESG performance indicators against which companies and the fund manager will be measured. It is important to ensure that the information on which these indicators are based is available: for example, evidence of environmental performance in terms of regulatory compliance issues and workplace performance indicators, such as base salary relative to other companies of similar size and in similar industries.
- Consider whether the fund manager develops company-specific strategies for improving the management of ESG issues prior to investment, then requires portfolio companies to measure and report against these goals.
- Look at whether the fund manager provides technical assistance to companies to assist with achieving greater integration of the salient ESG risks and opportunities associated with the business.

## Real Estate:

### **Key Opportunities for ESG Analysis and Impact:**

- Targeted investment in undeserved communities
- Provision of affordable and workforce housing
- “Smart growth” and conservation
- Energy efficient management and construction
- Sustainable product use
- Support for fair labor practices

### **Key Tools for ESG Measurement and Engagement:**

- ESG portfolio review for fund managers
- Advocate ESG reporting from investors and developers
- Set ESG performance standards for targeted investment
- Incorporate ESG factors into RFPs

### **Key Investment Product Types:**

- Fund managers with ESG management systems
- Private equity funds constructed with ESG criteria
- Pools of debt constructed with ESG criteria
- Developers with superior ESG performance
- REITS with superior ESG performance

### **Potential Benchmarks:**

Market-rates of return are typically determined by comparison to standard industry benchmarks. Real Estate investment types covered in this chapter vary widely; potential benchmarks might be, for instance, the NCREIF Property Index, the S&P GRA Commercial Real Estate Index, the Lehman Brothers Mortgage-Backed Securities Index, or the MSCI US REIT Index.

*Note: Investment products and organizations mentioned in this chapter are for illustrative purposes only, and should not be construed as investment advice. Responsible investors should in every case perform their own due diligence on potential investments.*

## I. Introduction

Real estate investments encompass a wide range of products, including home ownership for individuals, direct investments in rental properties and office and commercial space for institutional investors, publicly traded equities of real estate investment trusts, and fixed-income securities based on home-loans or other mortgages.

In this chapter, we examine both responsible investment issues for real estate as a hard asset—ranging from portfolios of existing properties to new development—and as securities backed by such hard assets and bundled together to form relatively liquid assets—such as Mortgage-Backed Securities (MBSs) and Real Estate Investment Trusts (REITs). Responsible investment issues are relevant to assessing long-term value creation across this full range of products.

### Real Estate and Responsible Investing

Real estate stands apart from other financial investments in that it is notably tied to hard assets and the historical development of communities. It shapes public policies and social mores and inevitably requires real estate investors to contend with and address the concerns of local communities and the physical environment in which development takes place. Environmental, social, and governance (ESG) analysis may help investors analyze the changing regulatory, social, and financial environments that help structure real estate investment returns.

Real estate investment decisions made about land-use, housing, urban and rural development, and transportation are not easy to undo, and their effects will last for decades to come. For this reason, and because real estate can be a relatively illiquid asset, real estate investments may particularly favor a long-term focus.

Real estate investments also offer unique opportunities for responsible investors to affect how and where people live, work, shop, and travel. They may:

- Promote energy efficiency
- Assure environmental health
- Increase use of sustainable construction materials
- Create jobs paying a living wage
- Invest in affordable housing
- Undertake urban revitalization
- Encourage public transportation

Taking social and environmental sustainability into consideration with real estate investments can add long-term value to this asset class without necessarily sacrificing market-rate returns. Here, we examine how ESG factors can be applied to five distinct aspects of the real estate market:

- Core real estate and existing construction
- Value-added real estate involving rehabilitation
- New development
- Mortgage-backed securities (MBSs)
- Real estate investment trusts (REITs)

Many diverse aspects of responsible real estate investment—such as its ability to support affordable housing, green building, and urban economic development—have shown up in dispersed and disconnected enterprises over the past several decades. In recent years, however, a trend has emerged showing increased interest, both in projects of these diverse sorts and in the incorporation of multiple social and environmental factors into single projects. Because real estate is a highly decentralized industry, it is only recently that coordination of efforts to create responsible investment opportunities has become a prominent theme.

## **II. Developing Responsible Real Estate Investment Strategies**

The built environment inevitably plays a role in the way humans relate to each other and to their natural surroundings. The goal for the responsible investor is to identify those areas where long-term social, environmental, and economic impacts can both impact and be created through the investment process.

Here, we identify six key factors that responsible investors can use to help define the economic, social, and environmental performance of their real estate investments. By analyzing these factors, responsible real estate investors can identify key opportunities for

- Engaging real estate managers, developers, and other real estate professionals to improve performance;
- Targeting new opportunities for creating superior performance in hard assets;
- Developing investment instruments that create positive social and/or environmental spillover effects while yielding acceptable or superior financial returns.

### **Factor 1: Affordability and Workforce Housing**

Social stratification and poverty can create severe social strains, lead to long commute times and increased energy consumption, and reduce workforce efficiency. In the United States, investment in tax-enhanced or public-private partnerships that support low-income homeownership or rental have long been a staple of commercial real estate investment. Affordable housing targeted to low-to-moderate income families is one of the most developed areas of responsible property investment.

Workforce housing—housing that supports middle-income families that are not poor, but may not have the means to live close to their workplace due to land, regulatory, or other constraints—offers responsible investors a similar opportunity to support public goods by reducing social strain, auto emissions, and levels of other energy use and by supporting a healthier, more effective workforce. Workforce housing investments have often targeted professions—for example, teachers, police, firefighters, and nurses—thought important to overall community health.

### **Factor 2: Local Economic and Brownfield Redevelopment**

Investment in rehabilitation and new construction may bring economic development to underserved areas, creating positive social externalities—such as vital services, new jobs, and a stabilized local tax base—through economic revitalization.

Similarly, “brownfield redevelopment”—the reclamation of environmentally damaged areas—may bring underperforming industrial sites back into economic productivity. In both cases, real estate investment creates a positive economic benefit for geographical areas that also increases the value of the investment itself.

### **Factor 3: Smart Growth, Transit-oriented Development, and Conservation**

Smart growth—loosely defined as the creation of walkable, mixed-use communities, and/or mixed-income communities—may create a healthy environment that improves real estate values across whole neighborhoods and increases tenant satisfaction and economic activity in commercial and residential real estate alike.

Transit-oriented redevelopment may reduce commute times, which may bring benefit to tenants and create environmental value through diminished auto use.

Conservation-oriented investment may find value in preserving green space, natural habitats, and wetlands, and so, can increase property values and provide for public goods, while simultaneously improving existing buildings through good management and refurbishment.

#### **Factor 4: Green Buildings and Environmental Efficiency**

Green buildings may reduce the consumption of resources throughout their lifecycle—water for cleaning and tenant use; electricity, oil, and gas for lighting, heating, and cooling; and materials for upkeep and rehabilitation. More efficient management systems and construction techniques, including more efficient lighting, heating, cooling, and water reclamation systems, may reduce costs and increase returns over the lifecycle of the building and can reduce greenhouse gas emissions and other pollutants. Design that allows for flexible use may reduce the resources needed for transforming building use over time. Green building applies both to new development and to the improvement of existing buildings through good management and refurbishment.

#### **Factor 5: Sustainable Construction and Materials**

Construction and maintenance materials form a substantial percentage of overall societal consumption, and more efficient, sustainable materials offer significant room for improving environmental performance. The use of environmentally sensitive building materials, such as sustainable timber or environmentally sensitive concrete, may improve a property's reputation as well as reduce harmful impacts. Similarly, the use of less toxic chemicals in building cleaning or maintenance may reduce negative environmental externalities and potentially improve a building's value by increasing tenant satisfaction and health. Owners and tenants help develop sustainability practices by purchasing sustainable products and by engaging with their existing supply chains.

#### **Factor 6: Fair Labor Practices**

A sizeable percentage of the workforce across the globe is employed in building, maintaining, or producing the materials needed for construction and maintenance. Applying fair labor practices, responsible contractor policies, and enhanced health and safety policies may improve labor performance, mitigate

against health problems and corporate reputation risks, and reduce the negative social externalities associated with poor labor practices.

Though these six factors will not cover all forms of responsible real estate investment, they do offer a framework for responsible investors to identify and engage in areas of concern.

### III. Opportunities in Responsible Real Estate Investment

How can investors act on their analysis and engagement on ESG issues in the real estate sector? If standard setting is fundamental to responsible investment, real estate investors who seek to create long-term value across the triple-bottom line need clear and consistent criteria defining what sorts of ESG performance evaluations determine the impact of any investment they are considering.

The key steps in responsible real estate investment are to:

- **Develop the vocabulary and metrics** for measuring and reporting on social and environmental performance.
- **Gather data** necessary to determine the financial, social, and environmental performance of investments.
- **Determine acceptable and exceptional levels of performance** for each of the key factors as they relate to real estate properties.
- **Evaluate opportunities for engagement** with the fund managers, developers, and other real estate professionals who may improve responsible investment performance.

These steps create different opportunities, depending on the type of real estate investment under consideration. In this Handbook, we examine five types of real estate investment: (1) core real estate and existing construction, (2) value-added real estate, (3) new development on properties in need of major refurbishment, (4) mortgage-backed Securities, and (5) Real Estate Investment Trusts.

The relative development of responsible real estate investment practices varies widely both within the asset class as a whole and across this range of investment types. The development of a standard vocabulary and set of metrics is in its infancy, as is the assessment of the relationship between responsible investment practices and financial returns.

*The Green Building Finance Consortium, a coalition of corporations, investors, lenders and developers, is working to create a methodology to appropriately value energy efficient construction. The Boston College Institute for Responsible Investment has organized a Responsible Property Investing Project to coordinate consensus-based vocabulary and metrics across the range of ESG issues.*

Nevertheless, in each investment type, there is a growing set of practices that offer responsible investors the chance to find and create value across the triple-bottom line, with demonstrated abilities to invest responsibly and achieve financial returns.

### **Core Real Estate and Existing Construction**

Core real estate holdings are the most usual form of hard asset investment for large institutional investors. Core real estate investments are typically geographically diversified, low-risk investments in high-quality buildings that require relatively little rehabilitation. Investors' key impacts are most likely either on building management or in the aggregation of buildings with a specific social or economic profile into a single portfolio.

In core real estate and existing buildings, responsible investors can work with their real estate investment partners to set standards and gather data on economic, social, and environmental performance.

They might develop systems to

- Employ ESG information gathering and management systems for the portfolio and its manager;
- Introduce portfolio-wide efforts to improve energy efficiency, for instance, by installation of more efficient lighting systems or enhanced insulation materials;
- Work with managers who maintain responsible sourcing policies and practices for building materials;
- Work with managers who maintain fair labor and responsible contractor policies.

Two United Kingdom-based property investors offer good examples of responsible property investment policies. **Prudential Property Investment Managers (PRUPIM)** has adopted a Corporate Responsibility initiative that addresses the dimensions of responsible investment, property management, construction, contractor and sourcing policies, and community investment, among others. A particular focus is on research into the relationship between responsible real estate investment practices and financial returns.

Similarly, **Hermes** has developed a set of responsible property investment guidelines that emphasize three areas of concern—environment, community, and stakeholders—across issues of compliance, good practice, strategy, and management systems. Hermes' guidelines seek to integrate responsible real estate analysis into the traditional financial and risk analysis applied to the long-term value of real estate holdings.

In these cases, active management of property investments may lead to improved governance of social and environmental criteria and may create financial value across the portfolio through reduced management costs, increased tenant satisfaction and retention, improved reputation of the portfolio manager and its investors, slower obsolescence, and mitigation of regulatory and litigation risks.

The **California Public Employees Retirement Plan (CalPERS)** has worked with its real estate partners to survey energy efficiency in its core real estate holding, with the goal of reducing energy use by 20% over the five-year period from 2006\_2010. Engagement has also led to increased awareness and action on hazardous product use, waste management, and other areas of environmental concern.

The adoption of responsible investment practices in core real estate offers the potential for creating a great deal of social and environmental benefit through marginal improvements across very large portfolios. While radical improvement—the restructuring of a large portfolio of multi-family apartments into

affordable housing or the creation of the highest ratings of energy efficiency across an existing portfolio—may be unlikely, engagement can lead to significant incremental improvements and real value creation.

Responsible investors may also invest in existing real estate portfolios that meet a certain level of social or environmental criteria, as shown in these examples:

- A portfolio-wide level of investment in affordable housing
- A portfolio of properties in underserved geographies
- A percentage of union labor in its labor force
- A standard for energy efficiency across the portfolio

In these cases, the development of clear and consistent criteria defining the social and/or or environmental profile of acceptable investments is necessary to create a responsible investment program. Investors may wish to work with outside consultants to create standards defining geographic areas where investment will create positive spillover effects on economic development. Investors may also turn to recognized industry standards on environmental performance to evaluate their investments' environmental profile.

**The United States Green Building Consortium** has developed an industry standard for building performance. The *Leadership for Energy Efficiency and Design (LEED)* allows investors to evaluate the environmental profile of both new construction and existing buildings. Similarly, the **Energy Star Program of the U.S. Environmental Protection Agency (EPA)** offers tools to measure building energy use.

**The General Board of Pensions and Health Benefits of the United Methodist Church** invests \$1.5 billion through community development financial institutions and other investment vehicles that support the preservation and creation of affordable housing initiatives, defined as housing that shelters people earning less than an area's median income.

## Value-added Real Estate

Value-added real estate investment involves the purchase of distressed or undervalued properties for enhancement and holding or resale. Responsible investment practices are well-suited to playing a role in how ESG considerations can be brought to bear on the enhancement process—redevelopment offers opportunity. One particular avenue in value-added real estate is investment in a fund, frequently a closed-end fund whose purpose is the redevelopment of properties to maximize their social and/or environmental benefits, while the fund delivers market rate investment performance.

When investing in such a fund, investors can set standards for addressing how the fund

- Identifies where there are opportunities to find value in ESG enhancements;
- Describes and/or measure ESG impact;
- Builds a pipeline of relevant investment opportunities.

*Several opportunities have emerged around the potential for social and/or environmental value creation that enhances financial returns in the value-added real estate sector. In the United States, the **Bay State Area Smart Growth Fund** in San Francisco and the **UrbanAmerica Funds**, headquartered in New York but operating nationally, both target underserved communities, where opportunities exist for profitable investment that takes advantage of existing infrastructure and community demand for jobs and services. In the United Kingdom, the **Morley Igloo Regeneration Fund** targets underserved communities and brownfield sites.*

*Targeted investment for social returns often overlaps with the potential for environmental value creation. The **Jonathan Rose Company** manages the **Rose Smart Growth Fund**, which seeks out urban infill investments with potential for reduced operating costs through environmental efficiency. **Cherokee Investment Partners** has developed a specialty in revitalizing brownfield sites to add value and increase returns.*

Particular types of social development, such as smart growth, urban infill, transit-oriented, or brownfield redevelopment may be well-placed in the value-added real estate sector. The social and/or environmental benefits gained through redevelopment can add reputational value to buildings themselves and raise property values across the immediate geographical area in which the development takes place.

In addition, funds that work with local partners such as local community development organizations to identify opportunities for positive spillover effects, may help reduce bureaucratic and regulatory costs and improve stakeholder relations. Finally, the positive externalities associated with rehabilitated land, reduced commute times, vibrant economic activity, and other factors offers significant opportunity for long-term value-creation across the triple-bottom line.

## **New Development**

New development involves either new construction or major refurbishment of existing buildings. This sector of real estate investment is the riskiest, but it is also an area that allows for innovative and high-impact creation of ESG benefits. Among other benefits, new construction can allow for innovations in land-use planning, as demonstration projects in one community lead to adaptation in another. New construction offers the potential of incorporating sophisticated technological and engineering solutions to environmental impact, of direct targeting for economic development, and of achieving fuller control over the labor force and supplies that go into construction.

For investors, the ESG benefits in new development are especially tangible—space and regulatory constraints often mean that creating superior development directly displaces a less desirable alternative.

Investors will require more complete due diligence processes to enter this sector, whether through opportunistic funds or in support of specific development projects. Responsible investors will require similarly elaborate due diligence processes to cover the range of issues in new or substantially rehabilitated properties. Responsible investors will want to determine:

- The standards for new development, external or internal, that demonstrate ESG performance;
- The track record of developers and related parties for delivering such performance while producing financial returns;
- The potential for new development to serve distressed communities or other targeted populations.

Financial results for new development can be difficult to predict; the same is likely true for the ESG benefits from new development, especially for areas in which there are no clear metrics for analysis.

However, the variety of opportunities, and the potential for visionary land-use, architectural, and engineering solutions to important social and environmental questions, makes new development a potentially high-return environment across the triple-bottom line as well.

*Full Spectrum, a development company in New York City, has built a green, affordable condominium structure in Harlem that integrates state-of-the-art environmental technologies with the intent to create affordable housing with low maintenance costs and low tenant turnover. The Noisette Community, a triple-bottom line development in North Charleston, SC, integrates environmental sustainability and social services into its land-use planning and property development and management services.*

## Mortgage-Backed Securities

Mortgage-backed securities (MBSs) are fixed-income investments (see also Chapter Three) that, when developed responsibly, can offer market-rates of return and also produce positive ESG impacts. These securities can support, for instance, pools of mortgages tied to affordable housing or community redevelopment. Recent interest in the creation of green mortgage-backed securities suggests that the market for environmentally oriented MBSs is growing.

When evaluating MBSs, investors should examine how the social and environmental information is collected and reported. Key information may include

- The percentage of a security devoted to low- and moderate-income families;
- The method used to determine how a geographic region is considered “underserved,” including income levels, ethnic composition, or the relative availability of affordable housing;
- The factors that create “green” pools of mortgages, including the standards for environmentally sound refurbishment or new construction that qualify individual mortgages.

*The US Government National Mortgage Association (Ginnie Mae) bundles together mortgages that serve low- to moderate-income families, as a means to increase access to homeownership by reducing the costs of mortgage credit, many through MBSs.*

In each of these cases, the ESG profile of MBSs depends heavily on the methods used to target the investment that will create a specific public good or serve a specific underserved community. The standards that investors set, in the aggregate, come to define a market segment dedicated to the creation of a particular sort of public benefit.

### **Real Estate Investment Trusts**

Real Estate Investment Trusts (REITs) are investment vehicles designed to allow smaller institutions and individual investors the opportunity to invest in real estate; they play an analogous role in real estate that mutual funds play in the public equity market. Especially if they are publicly held, REITs offer responsible investors the opportunity to engage with corporate responsibility practices in a manner similar to that of public equities.

To date, REITs have generally received relatively less scrutiny than public equities, although investors have filed shareholder resolutions with REITs on issues such as climate change, and a few REITs have published sustainability reports that relate ESG performance indicators and goals. Responsible real estate investors may have an opportunity to effect change through the engagement process. Responsible investors can engage with REITs from two perspectives:

- Existing management systems to address ESG risks and opportunities
- Information on portfolio-wide ESG profiles

*The **Forward Progressive Real Estate Fund** invests in publicly traded real estate companies, primarily REITs, integrating financial, geographic, and governance analysis with an environmental screening mechanism that targets companies with strong energy and resource efficiency, environmental impact mitigation, and stakeholder relationship policies.*

In addition, REITs, as an investment vehicle, offer at least the potential of a targeted selection of properties with a specific ESG profile, such as the creation of a “green” REIT comprised of energy efficient or otherwise environmentally sensitive properties, or a REIT that dedicates resources to improving the energy efficiency of its existing stock of buildings. To date, specifically green REITs have not yet developed, though recently, they have been much discussed in the real estate industry.

# Hedge Funds:

## **Key Opportunities for ESG Analysis and Impact:**

- ESG analysis for underlying assets
- ESG issues to identify arbitrage opportunities
- Protect portfolio positions to enable greater ESG impact
- Support long-term value-generating trading strategies
- Identify ESG implications of trading strategies

## **Key Tools for ESG Measurement and Engagement:**

- Advocacy for increased ESG transparency
- Support for ESG shareholder engagement

## **Potential Benchmarks:**

Market-rates of return are typically determined by comparison to standard industry benchmarks. A variety of benchmarks exist for hedge fund performance: see, for instance, the MSCI Hedge Fund Indices.

*Note: Investment products and organizations mentioned in this chapter are for illustrative purposes only, and should not be construed as investment advice. Responsible investors should in every case perform their own due diligence on potential investments.*

# Hedge Funds

## I. Introduction

Hedge funds are private investment vehicles available primarily to institutional investors and high-net-worth individuals. Although they are treated as a separate asset class in this *Handbook*, the underlying assets in which they invest are generally publicly listed securities (stocks and bonds) and their derivative products.

As private investment vehicles, hedge funds operate in a far less stringent regulatory environment than publicly traded stock and bond funds. This affords them the flexibility to invest in a broader range of financial instruments and use trading strategies not available to other investment vehicles. It also means they are subject to less onerous disclosure requirements.

By focusing on absolute returns and using alternative investments and trading strategies to de-correlate returns from the market, hedge funds in theory offer investors opportunities to achieve substantial returns and mitigate against the risk of a market downturn. However, in practice, many hedge funds are focused more on achieving superior returns than hedging risk, and hedge funds tend to charge high management fees.

Because of their esoteric nature, high fees, and lack of transparency, hedge funds have only recently become a more broadly accepted investment choice among institutional investors. Their recent popularity has made them a powerful force in the financial community.

In this chapter, we focus on several investment practices common to the wide range of hedge funds currently available and examine the ways in which responsible investment might relate to these practices.

### Hedge Funds and Responsible Investing

As an asset class, hedge funds may offer unique opportunities for responsible investors to address issues of risks and rewards—whether financial, social, or environmental. Hedge funds can also help investors

- Assess the nature and wisdom of the financial risks and rewards implicit in major investments, including opportunistic trading and short-term investment, short positions and their impact on engagement, and transparency of investment decisions
- Consider the ESG risks sometimes associated with hedge funds and their trading strategies

Since hedge funds often invest in the public equities and fixed-income markets, the opportunities to integrate environmental, social, and governance (ESG) factors and to influence corporate management to improve their ESG measurement and performance help create public goods and channel funds to the historically underserved are theoretically similar to those in these two other asset classes. (See Chapters Two and Three for more details.) These opportunities, however, are often limited by the trading and transparency policies of the hedge fund managers mentioned above.

Hedge fund managers are often portrayed as hard-nosed investors solely interested in short-term profit and without a social or environmental conscience. There is, however, nothing inherent in the techniques used by hedge fund managers that prevent them from incorporating ESG factors or from adopting responsible disclosure and management practices. Within the past five years, a small number of self-identified, socially responsible hedge funds have been launched, but ESG investment opportunities in this asset class remain relatively few and far between.

Finally, this Handbook does not directly address either the fee structure or the management reward incentives of hedge funds, but we acknowledge that investors may consider these important governance questions.

## II. Developing Responsible Investment and Hedge Fund Trading Strategies

Some of the issues that may concern responsible investors regarding the investment products and trading strategies used by hedge funds include (1) opportunism and the short-term holding of securities, (2) taking short positions, and (3) the transparency of investment decisions.

A key attribute of hedge funds is their ability to invest in a range of financial products in addition to equity and to take both long and short positions in those products. Hedge funds may invest across different asset classes, from public equities and their derivative products, to fixed-income products, futures contracts, or currencies. Despite the diversity that exists, hedge funds can be divided into three broad categories:

- **Convergence approach.** The investor bets that the price of multiple markets in similar securities will get closer over time as markets become more efficient. Some examples of convergence strategies include convertible arbitrage, equity (or index) arbitrage, mortgage arbitrage, fixed-income arbitrage, and merger arbitrage.

- **Security selection approach.** The investor identifies and exploits market misvaluations of specific securities. Some examples include equity long/short, distressed securities, and market-neutral funds.
- **Divergence approach.** The investor bets that the prices of markets of securities will move apart because of changes in external conditions. Some examples include global macro strategies and managed futures.

The great variety of strategies associated within hedge funds as an asset class means that not all funds employ all of these trading approaches. Indeed, some hedge funds look remarkably similar to other long-only equity funds—an equity-based hedge fund may be long only but be focused on short-term opportunities for arbitrage, resulting in a high turnover of investments. Alternatively, the fund strategy may be either to make larger, less liquid positions that have high risk and high-return potential or, alternatively, not take opportunistic positions at all.

Responsible investors should identify which of these approaches they are comfortable adopting within their portfolios and seek the information needed from their fund managers in order to assess the strategies.

### **Strategy: Opportunistic Trading and Short-term Investment**

Contrary to popular press about hedge funds, short-term trading is not a prerequisite for inclusion in the hedge fund asset class. However, as the performance of these funds is often driven by their flexibility and ability to seize opportunities to capitalize on market imperfections, hedge funds do often take short-term positions. This may contribute to the “churning” of portfolios and increase the pressure felt by corporate managers to focus on short-term performance to the detriment of the bigger picture. On the other hand, investors may consider that such churning adds discipline and liquidity to the market and plays an important role in sending signals to companies that investors believe are poorly managed—whether or not they are also performing well on ESG measures.

Responsible investors may identify opportunities for short-term trading that raise the profile of ESG considerations, which in turn can have a material impact on price. By doing so, responsible investors are able to impress the importance of these issues to both managers and other investors.

Alternatively, responsible investors may decide that engaging in short-term trading contributes to market myopia and is not a practice with which they are comfortable adopting.

As with other responsible investment strategies, engagement opportunities exist for hedge fund investors who wish to exercise ownership and other rights as shareholders of both the public and private companies in their portfolios. Hedge fund activism has featured prominently in the business news of late—and, more often than not has been reported on in an unfavorable light. Whatever view is taken on hedge fund activism, there is little doubt among commentators that hedge fund managers now exert a great deal of influence over management. For responsible investors, this signals an opportunity to encourage their hedge fund managers to use the same techniques to have a positive influence on the company’s treatment of ESG issues.

### **Strategy: Short Positions and Their Impact on Engagement Opportunities**

Two issues arise with respect to shorting stocks:

- The impact that the transaction’s legal structure has on ownership rights
- The signal that is being sent by shorting a stock

By taking the short position in a stock or other asset, the investor is betting that its market value will decrease. “Shorting” involves borrowing shares, selling them at the current market price, then repurchasing the shares prior to the date they must be returned to the lender—if successful, for less than their original price. Depending on the timing of the transaction, this may impact on the fund manager’s ability to vote as a shareholder.

Other instruments used for taking a short position, for example, contracts for difference, result in the hedge fund never actually being the owner of the underlying security. Rather, the difference in the final price is settled in cash by the respective parties. In this case, there is no opportunity to participate in corporate governance.

Responsible investors must therefore consider the importance of engagement with companies to their approach to responsible investment when considering whether the manner in which their fund manager practices shorting is consistent with their overall approach.

On the positive side, shorting is a way for responsible investors to profit from their insight into the materiality of ESG risks rather than just divesting a stock and preventing capital loss.

In an ideal world, responsible investors may want to short those companies they view as underperforming in ESG issues and take a long position in those they

believe will perform well, thus benefiting from the additional insight provided by recognizing the long-term impact that good management of these issues has on company performance. However, in order for such a shorting strategy to work from a financial perspective, there must be a connection between the market movements of the stocks and the issues identified by the investor. Even if poor management of environmental issues impact negatively on the share price in the longer term, unless the impact is felt at the time of the play, the responsible investor will not benefit from this insight.

These issues are additionally complex, as investors may find opportunities to profit by shorting companies that might otherwise be top ESG performers.

For some responsible investors, benefiting from the short position, namely, the poor performance of the stock of a company with a strong ESG record, creates no problems. However, other responsible investors may argue that looking only at the short-term performance of the company, which shorting requires investors to do, undermines the longer term focus that ought to accompany responsible investment. Ultimately, responsible investors should consider these two key issues regarding short selling:

- Are they prepared to forgo opportunities for engagement by short selling stocks?
- Are they prepared to benefit from the poor performance of shares in a company that otherwise meets their ESG criteria and stands to generate long-term value through its positive management of these issues?

### **Strategy: Transparency of Investment Decisions**

The private structure of hedge funds means that they are subject to less onerous disclosure requirements than other common investment vehicles. In addition, their focus on capitalizing on information asymmetries and market imperfections means that hedge funds tend to reveal less information about their share-selection strategies. Investors know less about the trading movements of a hedge fund than they would, say, about those of a mutual fund.

Again, not all hedge funds are alike. Investors should demand the information they need to properly assess the approach taken to applying ESG concerns into the investment process and the hedge fund's overall strategy. Similar to private equity funds, hedge funds tend to have fewer investors. If there is a concern about the quality of information, there may exist the ability to engage directly with the fund manager to find out the particular ESG impacts being achieved by the fund.

Responsible investors should, as with other asset classes, demand transparency from hedge fund managers about their voting policies and governance guidelines. Particularly where funds managers have considerable influence over managers, it is important that investors are satisfied that such influence is being used in a manner consistent with their priorities.

Access to information about the fund manager's strategy is fundamental to a responsible investor. At a minimum, responsible investors should demand that hedge fund managers provide information about

- Geographic and sector focus of the fund;
- Proxy voting and governance guidelines;
- Treatment of ESG issues.

Responsible investors may meet resistance when it comes to the fund manager's treatment of ESG issues, as this may require providing information on a company-specific basis, something that hedge funds prefer not to provide. As a compromise, responsible investors should ask for information to be provided either on an aggregate level or accept information on a delayed basis so that the fund manager does not feel the fund's strategy may be compromised. Responsible investors would then be able to review, albeit on a delayed basis, whether their hedge fund is performing consistently with their ESG concerns.

### **III. Opportunities for Responsible Hedge Fund Investment**

Hedge funds targeted at responsible investors are a small but growing market. Although some funds are currently available, and others are in the pipeline, more than any other asset class, responsible investors also have an opportunity to support and define the field of responsible hedge funds by creating demand.

**The Good Steward Fund (GSF)** is a fund of hedge funds operated by Highland Associates and managed by AIG. Representing \$180 million when it was formed in 2004, the GSF in 2007 totals \$320 million. Funds are selected first on a financial basis, then on the way that they are able to integrate the priority key ESG issues of the GSF's faith-based investors. This includes applying a negative screen to exclude companies that do not meet GSF's criteria, applying positive screens for strong social performance, and assigning the authority to vote proxies to GSF. The fund managers are then required to maintain a separate account for the GSF and present an integrated report on the fund's social and financial performance.

Within the different strategies used by hedge funds, there are opportunities to integrate ESG considerations into the selection of the fund's underlying assets in the same way as when adopting a long-only approach is taken or investment is made in the other asset classes listed in this Handbook. For example, screening techniques can be used to

- Invest in those companies that are leaders with respect to their ESG performance;
- Avoid investment (or take short positions) in companies operating in industries or markets that investors consider socially unacceptable;
- Support investment in the currencies of countries that are taking steps to combat corruption;
- Invest in fixed-income products, such as, for example, in mortgages that support underserved communities or environmental projects.

**Ardsley Partners** launched its **Renewable Energy Fund** in July 2006. The fund is a long/short equity fund focused on renewable energy and sustainable development issues, such as water sourcing/availability and enhanced food production methods. The selection techniques used to determine this investment universe are the same as those applied to a public equity mutual fund; however, Ardsley is able to take both a long and short position in the companies that meet its criteria. This means taking a long position in those companies it believes are either growth stocks or value companies and taking a short position in those that it believes are currently or will be underperforming because of poor management or legacy technology.

**GLG Partners European Equity Fund.** In January 2007, GLG Partners launched a new fund, based on its existing European Equities Fund, which would invest only in those companies performing best in their class, according to environmental data provided by **Trucost**. Back-testing of the strategy suggests that investing only in those companies in the portfolio that out-performed their industry peers in terms of environmental performance increased the fund's overall returns.

Methods for integrating ESG into the investment decisions are outlined in more detail in other chapters of this Handbook. As the underlying assets of hedge funds are the same, these techniques can be applied by hedge fund managers.

**Winslow Management Company** operates a hedge fund that is targeted at companies with strong environmental and governance records in the small- and mid-cap markets. The size of the companies means that Winslow is often a significant shareholder and can have a greater impact on management than would be possible in a larger company. Prior to investment, Winslow screens all companies according to their environmental and governance criteria and conducts an annual audit of its portfolio companies to ensure that they still meet the criteria. Where the audit identifies concerns, Winslow engages directly with management to resolve them. Furthermore, Winslow discloses its criteria to investors so that they are aware of outstanding issues relative to which companies are being monitored.

## Commodities:

### **Key Opportunities for ESG Analysis and Impact:**

- Focus on commodities with better ESG profile
- Consider the source (region) of the commodity

### **Key Tools for ESG Measurement and Engagement:**

- Support creation of ESG-based commodities criteria
- Advocate enhanced ESG reporting
- Create contracts that require sustainable production methods

### **Potential Benchmarks:**

Market-rates of return are typically determined by comparison to standard industry benchmarks. One potential commodity benchmark, for instance, is the S&P GSCI Commodity Index.

*Note: Investment products and organizations mentioned in this chapter are for illustrative purposes only, and should not be construed as investment advice. Responsible investors should in every case perform their own due diligence on potential investments.*

## I. Introduction

The trading in commodities is focused primarily on contracts speculating on the future price of various natural resources and agricultural products. (The futures markets in financial indexes and foreign currencies are not covered in this *Handbook*.) Commodity exchanges have developed to help lessen price risk to producers of agricultural products and natural resources, as well as managers of financial products.

A key feature of all commodities is substitutability, which allows those operating in the market to exchange contracts for delivery regardless of the origin of the product. Commodity markets, for example, provide the crucial service of helping both farmers and their customers mitigate price risk. But the requirement of substitutability and standardization of product has led to various criticisms, including the impact of this standardization on biodiversity, according to the United Nations Food and Agriculture Organization report *The State of the World's Animal Genetic Resources for Food and Agriculture*. Furthermore, access to commodities markets is not uniform across countries and is impacted by international trade agreements.

The commodities markets can be highly speculative and volatile. They are also often counter-cyclical to other financial products, such as stocks and bonds, and hence can serve a valuable role in diversification across asset classes. They are available to both individual and institutional investors.

In this chapter, we examine some of the ways in which responsible investment principles and concerns might be applied to today's commodities markets as the field matures.

### Commodities and Responsible Investing

Commodities, as an asset class, are tied directly to natural resources and agriculture. They potentially offer unique opportunities for responsible investors to influence how commerce interacts with our natural environment. Although little work has been done to date on the development of responsible commodities investment products, in theory responsible investment in commodities might help provide:

- A pricing mechanism for the environmental impacts of natural resources (e.g., carbon trading) and agriculture
- Pricing stability for natural resources that, in and of themselves, have environmentally preferable characteristics (e.g., natural gas over oil)

- Pricing stability for natural resources or agricultural products produced and marketed in a socially and environmentally preferable manner (e.g., fair trade or organic coffee)

Unlike other asset classes, few opportunities to incorporate environmental, social, and governance (ESG) factors into commodity trading currently exist. The one exception is the recent creation of a carbon-trading market, the entire purpose of which is to address the environmental problem of global climate change.

This suggests the intriguing possibility of using commodity markets to price the environmental effects of various natural resources or the risks associated with food supply and production. Two innovations in the current commodities markets involving the integration of sustainability issues would facilitate the development of commodities vehicles appropriate for responsible investors:

- Creation of sub-categories of commodities with preferable sustainability aspects that could be separately traded on exchanges
- Standard setting for ESG impacts that occur during the production processes of commodities

## **II. Developing Responsible Commodities Investment Strategies**

As noted, responsible investment in commodities remains more an idea to be explored than a developed practice. In this section, we consider some of issues and strategies that might create a responsible investment market in commodities.

Commodities markets involve trading in contracts for the supply of a particular product. Trading requires specific knowledge of the particular market, since there is great variation in structures and the number of players, as well as regional differences in the product. This complexity means that responsible investors may need to adapt their responsible investment strategy to the underlying product in which they are trading.

Another distinguishing feature of the commodities market is that, unlike the equities market, bad news for the production of a commodity results in a reduction in supply and generally drives prices up. Further, the impacts of news related to negative social and particularly environmental effects, such as climate change, disease, or poor governance systems that impede a producer's ability

to uphold their commitments, are far more direct in the commodities market. This will allow responsible investors greater opportunity to benefit from the added insight that considering these factors may provide. However, it should be noted that commodities markets operate on short-term cycles, so the ability to predict the timing of the adverse impacts is critical.

There are three primary ways to participate in the market. The first is by direct investment through an authorized broker—generally done only by sophisticated investors with adequate capital to achieve diversification in the asset class. The second is through investment in an exchange-traded fund that is linked to a basket of commodities. The third is through investment in commodities derivatives, such as notes linked to commodities.

Participants in commodities markets fall into two groups: hedgers and speculators. Hedgers are those who use futures contracts to “hedge” their position as a buyer or seller of the underlying product. For example, a company that uses rubber as part of its production process can use the commodity markets to reduce the price risk of the raw product, thus allowing for greater price stability that, in turn, assists in business planning. Similarly, governments, particularly those of developing countries, may also use commodities markets to allow for more certainty in food prices and budgeting.

Speculators are those who do not use the commodity in their production process, but rather, wish to profit from price fluctuations by trying to predict the way the market is likely to move. Speculators play an important role in the market by creating the liquidity that allows hedgers to mitigate against price risk.

Two strategies may be used by responsible investors to integrate ESG issues into their commodity selection processes: (1) focus on the commodity itself being traded or (2) focus on the origin or source of the commodity.

### **Strategy: Focus on the Commodity Being Traded**

Selecting commodities based on the underlying product itself is similar to applying positive and negative screens, as examined in other chapters. Namely, responsible investors can identify certain types of commodities that they want to

- Eliminate from their portfolio due to the negative impacts that either the product or its production process create;
- Emphasize in their portfolios due to the more positive characteristics of the product.

Responsible investors may choose to align these screens with their current portfolio screens, where this is appropriate. For example, investors may develop an index based on the Dow Jones-AIG Commodities Index that excludes certain problematic products. The commodities currently held in the Index include:

- Aluminum
- Corn
- Crude Oil
- Gold
- Heating oil
- Lean hogs
- Nickel
- Soybeans
- Silver
- Zinc
- Soybean Oil
- Coffee
- Cotton
- Copper
- Live cattle
- Natural gas
- Unleaded gasoline
- Sugar
- Wheat

*Carbon trading has been the most prominent example of the opportunities for investors to participate in markets established to create incentives for greenhouse gas reduction. Qualified investors can invest directly in the carbon market; otherwise, it is possible to invest through a broker. Arguably, due to the rationale of creating a product such as carbon certificates, investing in carbon is itself contributing to resolving a pressing ESG concern. Others may be more skeptical of both the incentives created by carbon markets and their efficacy in achieving their objective of greenhouse gas reduction. More information is available at the **Chicago Climate Exchange** ([www.chicagoclimatex.com](http://www.chicagoclimatex.com)) and the **European Climate Exchange** ([www.europeanclimateexchange.com](http://www.europeanclimateexchange.com)).*

One strategy might be emphasizing natural gas as an alternative to crude oil among the energy commodities. Responsible investors may prefer aluminum to other metals, as it can be used for lighter weight cars and recyclable products. Or, they may decide to invest in lumber or timber products but exclude investment in cattle since they are a resource-intensive meat source. Sugar and corn offer opportunities for alternative fuel production, and ethanol is already listed on the Chicago Board of Trade—but there are important social implications for the world’s food supply in the development of biofuels. By contributing to improving the liquidity in these areas, responsible investors may be able to assist producers to achieve greater price stability and improve performance.

### **Strategy: Focusing on the Source of the Commodity**

In order to facilitate the operation of commodity exchanges, contracts must be interchangeable. Consequently, in many instances, it is the exchange that is listed as the counter-party to the agreement, meaning that it is not possible to identify the actual producer—even if this were practically possible during trading. In this regard, negative screens, such as those described in other chapters, may be harder to apply to commodities investment. Even so, some commodities are offered on a regional basis.

For example, oil and minerals traded on the New York Mercantile Exchange are described by region, such as “Brent Crude” and “Asian Gold” while the Chicago Board of Trade has “South American Soy Beans” among its products. Responsible investors may wish to focus on those regions that have the highest standards according to their ESG criteria.

Therefore, investors still have some scope to consider the qualities and risks associated with the particular region and build this into their investment decisions. It may be possible to assess risks associated with poor standards of environmental regulation, human rights violations, or corruption at a regional level. Similarly, responsible investors may achieve performance insights by focusing on those regions that outperform on similar ESG indicators.

## **III. Opportunities for Responsible Commodities Investment**

Although commodities markets and trading affect the production of goods essential to our daily lives, there are, as yet, few ways to foster positive ESG changes through the investment process itself. Therefore, responsible investors may advocate change on a broader level within the commodities exchanges—as has been done in the public equities market. As a start, responsible investors require two key changes in order to better integrate ESG issues into their investment decisions:

- Industry-wide initiatives to set standards for ESG impacts that occur during the production process
- The creation of sub-categories of commodities on listed exchanges that permit trading in limited groups of commodities

## Standards for Production

Standards for production already exist for many commodity products; however, commodity exchanges do not include certification requirements in their contract specifications. This means that the producers who do adhere to such standards are not properly rewarded for their effort. Similarly, no premium is paid for products that are produced according to higher standards, even though this may reduce risks that impair the ability to fulfill the contract and lead to longer term price stability. Given that the commodity exchanges account for such a great percentage of the volume of goods traded, requiring adherence to global standards in order to list a contract for sale entails enormous potential impact.

*The Forest Stewardship Council (FSC) sets principles, standards, and criteria for responsible forestry management and practices and provides independent certification to timber producers. The standards are intended to promote sound environmental stewardship and greater respect for local and indigenous communities affected by forestry production. Requiring FSC Certification as a contract term of commodity trades would promote far greater uptake of the standards. In turn, this would have a positive impact on sustainability of forestry production.*

## Creation of Sub-categories of Commodities

With sufficient consumer demand, it may be possible to create a distinct class for different commodity products based on third-party certification. In order to avoid market manipulation, the underlying cash market for a product listed on a commodity exchange must be sufficiently large for sub-classes to be successful. Consideration should also be given as to the impact of increasing the technical standards on facilitating greater access to commodity markets by emerging market producers. Raising the bar too high, however, may further inhibit their ability to benefit from international trade.

Responsible investors may wish to promote certification schemes that encourage more responsible production practices at both a voluntary and mandatory level. In addition, responsible investors may search for and promote opportunities for gaining exposure to the commodities markets in a way consistent with their ESG concerns. Just as importantly, responsible investors may advocate that commodity exchanges create opportunities to invest in such products.

# Note on Emerging Markets

“Emerging markets” is a term notoriously difficult to define. Here, we take the term to refer to those countries and regions with a relatively low median per capita income level. Associated characteristics frequently include less elaborate investment opportunities, financial infrastructure, or regulatory mechanisms than in the world’s richest countries and regions. We should note up front that the differences among emerging markets are at least as large as those between emerging and developed markets. A term that covers economies as disparate as those of China, Indonesia, Ghana, Brazil, El Salvador, and Poland obviously deserves a great deal of scrutiny.

In recent years, investors have often looked to emerging markets as sources of potentially higher returns, as poorer countries may offer opportunity for more rapid economic growth than their richer counterparts. Investor focus has moved beyond emerging market government bonds, which bring with them exposure to the country’s whole economy—instead, there is a shift toward incorporating a wider variety of instruments in emerging markets, including public stocks, corporate bonds, and private equity. Emerging markets are also often associated with higher levels of risk, particularly political, governance, and currency risk.

## Responsible Investment and Emerging Markets

Emerging markets are not an asset class, and the discipline of responsible investment can be applied to emerging markets across the various asset classes, as outlined in this *Handbook*. To date, relatively few assets have been devoted to emerging market responsible investments, although that appears to be changing, especially in the larger emerging markets such as Brazil, which recently saw the opening of the first emerging market sustainable investment index fund.

There are particularities to emerging market responsible investments that distinguish them from their developed market counterparts.

First, because of regulatory differences, issues of transparency, and the complexities of responsible investment practices in different cultural and governmental contexts, it can be difficult for offshore responsible investors to gather the information necessary to make informed choices based on environmental, social, and governance (ESG) data. However, by creating demand for this type of information and demonstrating its importance for sound investment decision making, responsible investors may help integrate sustainability into emerging markets.

Second, the relative underdevelopment of emerging market economies can potentially create outsized opportunities for achieving positive ESG impacts, including

- Creating incentives for companies (and economies) to integrate socially and/or environmentally sustainable practices from an early stage
- Engaging with corporations and governments to institutionalize more effective corporate governance policies
- Filling financing gaps created by market inefficiencies or information asymmetries that prevent access to appropriate capital
- Demonstrating the potential value that can be generated by integrating ESG into investment decisions by local investors—both in terms of impact and in financial returns

We briefly outline several ESG opportunities for long-term wealth creation that emerging markets offer in particular. We do not examine the more general opportunities for incorporating ESG analysis into emerging market investment, as these are covered by asset class in the previous chapters.

Finally, we should note that several emerging market investment opportunities take the form of either public/private partnerships or collaborative efforts between investors and multilateral institutions. While this note does not directly address these partnerships, we understand them to be a key component in the growth and development of responsible investment in emerging markets.

*Note: Investment products and organizations mentioned in this chapter are for illustrative purposes only, and should not be construed as investment advice. Responsible investors should in every case perform their own due diligence on potential investments.*

## **I. Advocacy for Increased Transparency Around ESG Issues**

One of the key factors limiting responsible investment in emerging markets is the difficulty of research on ESG data. In many emerging markets, responsible investment remains a relatively unknown concept, and there is a consequent lack of reporting from public and private companies on their ESG performance. At the same time, corporate disclosure requirements and other corporate governance mechanisms, in general, are often less elaborate than in developed economies, and this generally reduced transparency may require alternative means for investors to evaluate risk. Responsible investors may wish to support initiatives—both governmental and nongovernmental—that increase access to ESG information in the markets in which they wish to invest.

**The Asian Socially Responsible Investment Association (ASrIA)** released a 2006 study entitled, *“Taking Stock: Adding Sustainability Variables to Asian Sectoral Analysis.”* The study concluded that, as of now, investors have little access to key material ESG data when analyzing Asian markets, both because of relatively less government collection of key data and the relative lack of corporate transparency relative to developed markets. *“Taking Stock”* also highlights the key ESG issues—from environmental sustainability concerns to supply chain and human rights issues—that are likely to drive increased interest in various sectors of publicly listed Asian markets. According to the study, key developments in ESG disclosure and analysis will likely be driven by changing social expectations from an increasingly wealthy citizenry and increased governmental attention to environmental issues.

Responsible investors must take into account the difficulties in producing information in emerging markets. In particular, investors should note that different cultural contexts may create different priorities and perspectives in analyzing various ESG indicators. Advocacy around disclosure should ensure that emphasis is placed on those ESG indicators that do add value to companies, given the local context and their particular business risks and opportunities.

There is some evidence that use of sustainability indicators can be used as proxies for good corporate management and governance in emerging markets. As highlighted in the IFC report *Towards Sustainable and Responsible Investment in Emerging Markets: A Review of the Social Investment Industry’s Activities and Potential in Emerging Markets*, a series of studies has noted the potential for corporate social and environmental responsibility practices to add business value to emerging market corporations. Therefore, advocating for increased disclosure should not necessarily be seen only as a burden for emerging market companies; rather, it also presents an opportunity to improve investor confidence—both of local and international investors.

Emerging market companies may use corporate social and environmental responsibility practices to mitigate reputational risk and to increase access to co-investment and support from multinational corporations. For instance, a recent survey by the United Nations Environment Program Finance Initiative (UNEP FI) of banking practices in Nigeria and South Africa entitled *Banking on Value: A New Approach to Credit Risk* found that the main driver of the sustainability agenda for those two countries’ banks was the potential for enhanced reputa-

tion to open doors to collaboration with foreign banks and multilateral lending institutions. Similar opportunities may exist for smaller unlisted companies to make themselves attractive as partners for multinational companies who have implemented enhanced ESG standards in their supply chain mandates.

*In early 2000, India adopted comprehensive corporate governance reforms, which were largely similar to the changes introduced in the United States by the Sarbanes Oxley Act. The changes implemented by Clause 49 include independent director requirements, establishment of audit committees, CEO/CFO certification of financial statements, and whistleblower protections. A recent study of Clause 49 showed a positive reaction to the changes, with indications that investors expected the reforms to increase the market value of firms subject to the new disclosure requirements. See “Can Corporate Governance Increase Firms’ Market Value? Evidence from India,” by Vikramaditya Khanna and Bernard Black (Journal of Empirical Legal Studies, 2007).*

## II. Opportunities for Environmentally Sensitive Investment

Emerging markets may offer responsible investors specific opportunities to address key environmental opportunities and risks associated with rising energy prices, climate change, resource and habitat depletion, and other challenges.

In many emerging markets, much of the infrastructure has yet to be built. For instance, much of the commercial, residential, and industrial real estate expected to be needed in emerging markets over the next 10 years has yet to be developed. Opportunities for energy-efficient construction, less land-intensive development patterns, and transportation-oriented development strategies may be richer than in developed markets. Responsible real estate investment may offer tools to create investment strategies that capitalize on the potential for new construction.

A key concern in poorer economies, as identified in the seminal UN World Commission on Environment and Development 1987 publication, *Our Common Future*, is that poverty itself puts strains on natural resources that sustainable economic development can help to mitigate. Along these lines, there are investments in ecologically friendly business practices—including, for instance, eco-tourism and environmentally sensitive agricultural production—that create jobs and conserve important ecological resources. Investment in ecologically

sensitive businesses may mitigate against reputational risk for investors and may also lead to stronger relationships with emerging market governments and international development agencies.

As always, these investments require careful consideration to assure that their promised environmental benefits actually materialize. Ecotourism, in particular, has received much criticism over the years for “greenwashing”—that is, putting an environmentally friendly face on unsustainable consumer practices. A careful consideration of environmental impacts may also help identify emerging market companies that have partnered with multinational companies who, as part of their own corporate responsibility, are implementing enhanced environmental and/or product safety strategies in their supply chains.

Finally, the development of sustainable infrastructure in emerging markets potentially offers responsible investors the opportunity to support alternative energy industries and environmentally friendly projects. As noted in Chapter One, the International Finance Corporation’s Equator Principles offer a model for project finance that allows investment banks to review the environmental and social implications of large-scale infrastructure development. Offshore investors may wish to apply similar principles when investing in private equity projects that support needed infrastructure development.

Alternative energy investments may prove particularly appealing in emerging markets where existing electricity grids, transportation systems, and related infrastructure makes traditional energy investments more difficult. Alternative energy investments offer the potential for valuable social and environmental benefits, as clean energy in polluted cities and solar and other forms of renewable energy for rural areas without electricity may help enhance both quality of life and economic performance. As emerging market demand for energy is expected to increase exponentially, and many investors fear rising energy prices, investments that focus on clean technology and other alternative energy investments may offer significant potential for long-term value creation across the triple-bottom line.

**Rio Bravo Investimentos, SA**, an investment manager based in Brazil with over \$2 billion in assets, operates a number of private equity funds focused on sustainability, including the **Rio Bravo Sustainability I Fund**. The focus of the fund is economically attractive enterprises in any sector that exerts a positive impact on the environment, society, or both. In addition, the fund will also invest in companies that are seeking capital to improve either their technologies or their processes—or some combination of both—to improve environmental or social performance.

### III. Opportunities for Investment that Creates Social Benefit

In the poorest emerging markets, almost all investments can be characterized as targeted investments that alleviate poverty. The techniques of targeted investment discussed earlier in this Handbook thus can apply to whole countries and regions, as well as to specific urban neighborhoods or rural villages. Responsible investors have enormous opportunities to create double- or triple-bottom line impacts in emerging markets, a testament to the scale of social problems such as poverty and disease.

Over the past 20 years, much attention has been concentrated on those investment opportunities in emerging markets that help alleviate poverty. Most prominent among these has been the development of microfinance—loosely defined as the provision of loans and other financial products to (typically very poor) micro-entrepreneurs who lack access to credit. (Note that microfinance is not limited to emerging markets, though it is often associated with them.) In recent years, thanks to longstanding philanthropic efforts and concentrated market development activity, for-profit microfinance institutions have come to market, offering investors the ability to achieve their targeted, market rates of return in certain microfinance investments.

*The **Dexia Micro-Credit Fund** finances over 60 microfinance institutions in over 20 different emerging markets. This fund is structured for commercial investors who seek a market rate of return.*

*For a good resource for general information on microfinance and related activities, see **The Microfinance Gateway** at [www.microfinancegateway.org](http://www.microfinancegateway.org); see also the **Consultative Group to Assist the Poor (CGAP)**, at [www.cgap.org](http://www.cgap.org).*

Recently, attention has also been focused on emerging market small- and medium-sized enterprises (SMEs), which offer the potential to link micro-entrepreneurs to large-scale businesses, support developing business climates, increase employment, and support the formal economy through tax payments. In many respects, the market for sustainable investment in emerging market SMEs resembles the market for microfinance 20 years ago, with multilateral

lenders, nonprofit organizations, and philanthropic institutions supporting the development of SME finance with soft loans and subsidized technical assistance for companies—this support comes from the belief that SMEs can play a vital role in economic development. The potential exists, however, for market-rate funds focused on SMEs that also document their social impacts, especially in the fields of job creation and tax generation.

*Several fund managers are taking an innovative approach to filling the financing gap that exists for emerging market SMEs, in particular those SMEs that also create positive social and environmental impact. By making investments (both debt and equity) in these ‘sustainable SMEs’, these funds are providing entrepreneurs with access to the finance that is so critical to business success. One such fund is **E+Co**. Originally developed by the **Rockefeller Foundation**, E+Co now issues a range of instruments for investors, including promissory notes, the funds raised from which are then invested in SMEs, thus providing more sustainable energy solutions to rural areas in developing countries. E+Co., and other similar organizations, are exploring ways to offer investments that yield these benefits while achieving commercially acceptable returns.*

Investors may also wish to examine emerging market companies and investment funds that concentrate on products that serve the interests of relatively poor consumers. The base of the pyramid—a term referring to the approximately 4 billion people living on less than \$2 a day—is a vast consumer group whose needs are largely unmet in the current economic environment. ESG analysis may help investors to identify those emerging market opportunities that are most likely to serve the needs of this group, and so most likely to create long-term value for investors and society alike. Particular opportunities may exist in product-focused investments that deliver healthcare, clean water, energy, and sustainable, affordable consumer products. As noted in the previous chapters, this sort of product-focused ESG analysis is a common tool for responsible investment, and it may have special applications in emerging markets.

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Hagerman, Lisa A., Gordon L. Clark, and Tessa Hebb. *Investment Intermediaries in Economic Development: Linking Pension Funds to Urban Revitalization*. Labor and Worklife Program, Harvard Law School, 2007. [www.community-wealth.com/\\_pdfs/articles-publications/state-local/paper-hagerman-et-al.pdf](http://www.community-wealth.com/_pdfs/articles-publications/state-local/paper-hagerman-et-al.pdf).

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World Economic Forum and AccountAbility. *Mainstreaming Responsible Investment*. London: AccountAbility, 2005. [www.accountability.org.uk/news/default.asp?id=144](http://www.accountability.org.uk/news/default.asp?id=144).

## Appendix: Links to Organizations and Referenced Readings

### Introduction

The United Nations Principles of Responsible Investment [www.unpri.org](http://www.unpri.org)

### Chapter One—Cash Deposits

#### *Examples of Responsible Cash Investments*

Bank of America [www.bankofamerica.com](http://www.bankofamerica.com)

Carver Federal Savings Bank [www.carverbank.com](http://www.carverbank.com)

Charity Bank [www.charitybank.com](http://www.charitybank.com)

Citigroup [www.citigroup.com](http://www.citigroup.com)

The Cooperative Bank [www.co-operativebank.co.uk](http://www.co-operativebank.co.uk)

Dexia [www.dexia.com](http://www.dexia.com)

Latino Community Credit Union [www.cooperativalatina.org](http://www.cooperativalatina.org)

Liberty Bank [www.liberty-bank.com](http://www.liberty-bank.com)

Native American Bancorporation [www.nabna.com](http://www.nabna.com)

Self-Help Credit Union [www.self-help.org](http://www.self-help.org)

ShoreBank [www.sbk.com](http://www.sbk.com)

Triodos Bank [www.triodos.com](http://www.triodos.com)

Wainwright Bank [www.wainwrightbank.com](http://www.wainwrightbank.com)

#### *Research and Advocacy Organizations*

The Community Investing Center (a project of the U.S. Social Investment Forum and Co-op America) [www.communityinvest.org](http://www.communityinvest.org)

Community Development Banker's Association  
[www.communitydevelopmentbanks.org](http://www.communitydevelopmentbanks.org)

Community Development Finance Institutions Fund [www.cdfifund.gov](http://www.cdfifund.gov)

The Equator Principles [www.equator-principles.com](http://www.equator-principles.com)

National Community Investment Fund [www.ncif.org](http://www.ncif.org)

National Federation of Community Development Credit Unions [www.natfed.org](http://www.natfed.org)

Opportunity Finance Network [www.opportunityfinance.net](http://www.opportunityfinance.net)

Promontory Financial Network [www.promnetwork.com](http://www.promnetwork.com)

**Further Reading**

Jed Emerson's Blended Value Website [www.blendedvalue.org](http://www.blendedvalue.org)

**Chapter Two—Fixed-Income****Examples of Responsible Fixed-Income Investments**

Access Capital Strategies [www.accesscapitalfunds.com](http://www.accesscapitalfunds.com)

Community Capital Management [www.ccmfixedincome.com](http://www.ccmfixedincome.com)

Dexia Sustainable Bonds Fund [www.dexia.com](http://www.dexia.com)

Domini Bond Fund [www.domini.com](http://www.domini.com)

Insight Investment [www.insightinvestment.com](http://www.insightinvestment.com)

J.P. Morgan Environmental Index-Carbon Beta [www.jpmorgan.com/jeni](http://www.jpmorgan.com/jeni)

Morley Sustainable Futures Corporate Bond Fund [www.morleyfm.com](http://www.morleyfm.com)

PaxWorld High Yield Fund [www.paxworld.com/hyf](http://www.paxworld.com/hyf)

Sarasin Sustainable Bonds Fund [www.sarasin.ch](http://www.sarasin.ch)

**Chapter Three—Public Equities****Research and Advocacy Organizations**

The Carbon Disclosure Project [www.cdproject.net](http://www.cdproject.net)

Davis Global Advisors [www.davisglobal.com](http://www.davisglobal.com)

The Enhanced Analytics Initiative [www.enhancedanalytics.com](http://www.enhancedanalytics.com)

The Global Reporting Initiative [www.globalreporting.org](http://www.globalreporting.org)

The Interfaith Center for Corporate Responsibility [www.iccr.org](http://www.iccr.org)

The Marathon Club [www.themarathonclub.org](http://www.themarathonclub.org)

The United Nations Environment Program Finance Initiative (UNEP FI)  
[www.unepfi.org](http://www.unepfi.org)

**Social Investment Forums**

ASrIA: Association for Sustainable and Responsible Investment in Asia  
[www.asria.org](http://www.asria.org)

The Canadian Social Investment Organization [www.socialinvestment.ca](http://www.socialinvestment.ca)

Ethical Investment Association Australasia [www.eia.org.au](http://www.eia.org.au)

Eurosif: The European Social Investment Forum [www.eurosif.org](http://www.eurosif.org)

UK SIF: The United Kingdom Social Investment Forum  
[www.uksif.org](http://www.uksif.org)

The U.S. Social Investment Forum [www.socialinvest.org](http://www.socialinvest.org)

**Examples of Responsible Public Equity Investment Opportunities**

ClearBridge Advisors [www.clearbridgeadvisors.com](http://www.clearbridgeadvisors.com)

Dow Jones Sustainability Indexes (DJSI) [www.sustainability-indexes.com](http://www.sustainability-indexes.com)

The F. B. Heron Foundation [www.fbheron.org/mission](http://www.fbheron.org/mission)

FTSE 4 Good Index Series [www.ftse.com/Indices/FTSE4Good\\_Index\\_Series](http://www.ftse.com/Indices/FTSE4Good_Index_Series)

Henderson Global Investors Global Care Growth Fund  
[www.henderson.com/home/sri](http://www.henderson.com/home/sri)

**Responsible Investment Research Firms**

EIRIS: Ethical Investment Research Services (UK-based) [www.eiris.org](http://www.eiris.org)

GES Investment Services (Sweden-based) [www.ges-invest.com](http://www.ges-invest.com)

Innovest: (Multiple Offices) [www.innovestgroup.com](http://www.innovestgroup.com)

Institutional Shareholder Services: (international)  
[www.riskmetrics.com/knowledge/environmental\\_social\\_governance.html](http://www.riskmetrics.com/knowledge/environmental_social_governance.html)

KLD Research and Analytics (US-based) [www.kld.com](http://www.kld.com)

Michael Jantzi Research Associates (Canada-based) [www.jantziresearch.com](http://www.jantziresearch.com)

SAM Group (Switzerland-based) [www.sam-group.com](http://www.sam-group.com)

SiRi Company (Switzerland-based) [www.siricompany.com](http://www.siricompany.com)

SIRIS (Australia-based) [www.siris.com.au](http://www.siris.com.au)

Vigeo (France-based) [www.vigeo.com](http://www.vigeo.com)

**Proxy Voting Services**

Glass Lewis [www.glasslewis.com](http://www.glasslewis.com)

ISS Global Proxy Services [www.issproxy.com](http://www.issproxy.com)

Pension and Investments Research Consultants (PIRC) [www.pirc.co.uk](http://www.pirc.co.uk)

**Further reading**

Academic Studies on Socially Responsible Investment [www.sristudies.org](http://www.sristudies.org)

Global Proxy Watch [www.davisglobal.com](http://www.davisglobal.com)

KPMG international survey of corporate responsibility reporting 2005  
[www.kpmg.nl/Docs/Corporate\\_Site/Publicaties/International\\_Survey\\_Corporate\\_Responsibility\\_2005.pdf](http://www.kpmg.nl/Docs/Corporate_Site/Publicaties/International_Survey_Corporate_Responsibility_2005.pdf)

Responsible Investor Website [www.responsible-investor.com](http://www.responsible-investor.com)

Social Funds Website [www.socialfunds.com](http://www.socialfunds.com)

## Chapter Four—Private Equity

### *Examples of Responsible Private Equity Investments*

Actis Capital [www.act.is](http://www.act.is)

Bay Area Equity Fund

[www.jpmorgan.com/pages/jpmorgan/investbk/global/na/baef](http://www.jpmorgan.com/pages/jpmorgan/investbk/global/na/baef)

Calvert Special Equities Fund [www.calvert.com](http://www.calvert.com)

CalPERS [www.calpers.ca.gov](http://www.calpers.ca.gov)

CalSTRS [www.calstrs.com](http://www.calstrs.com)

Emerald Technology Ventures [www.emerald-ventures.com](http://www.emerald-ventures.com)

MassPRIM [www.mapension.com](http://www.mapension.com)

Pacific Community Ventures [www.pacificcommunityventures.org](http://www.pacificcommunityventures.org)

SJF Ventures [www.sjfund.com](http://www.sjfund.com)

### *Research and Advocacy Organizations*

Cleantech Venture Network [www.cleantech.com](http://www.cleantech.com)

Initiative for a Competitive Inner City [www.icic.org](http://www.icic.org)

Investor's Circle [www.investorscircle.net](http://www.investorscircle.net)

The National Association of Investment Companies [www.naicvc.com](http://www.naicvc.com)

Small Business Administration's New Market Venture Capital Program  
[www.sba.gov](http://www.sba.gov)

Social Venture Network [www.svn.org](http://www.svn.org)

### *Further Reading*

The Double-Bottom Line Investment Handbook  
[www.sdsgroup.com/dbl-handbook.html](http://www.sdsgroup.com/dbl-handbook.html)

## Chapter Five—Real Estate

### *Examples of Responsible Real Estate Investments*

Bay State Area Smart Growth Fund [www.basgf.com](http://www.basgf.com)

CalPERS [www.calpers.ca.gov](http://www.calpers.ca.gov)

Cherokee Investment Partners [www.cherokeefund.com](http://www.cherokeefund.com)

Forward Progressive Real Estate Fund [www.forwardmgmt.com](http://www.forwardmgmt.com)

Full Spectrum [www.fullspectrumny.com](http://www.fullspectrumny.com)

General Board of Pensions and Health Benefits of the Methodist Church  
[www.gbophb.org](http://www.gbophb.org)

Hermes Real Estate [www.hermes.co.uk/real\\_estate](http://www.hermes.co.uk/real_estate)

Jonathan Rose Company [www.rosecompanies.com](http://www.rosecompanies.com)

Morley Igloo Regeneration Fund [www.morleyfm.com](http://www.morleyfm.com)

Noisette Community [www.noisettesc.com](http://www.noisettesc.com)

Prudential Property Investment Managers [www.prupim.com](http://www.prupim.com)

Urban America [www.urbanamerica.com](http://www.urbanamerica.com)

U.S. Government National Mortgage Association [www.ginniemae.gov](http://www.ginniemae.gov)

### ***Research and Advocacy Organizations***

US EPA Energy Star Program [www.energystar.gov](http://www.energystar.gov)

Green Building Finance Consortium [www.greenbuildingfc.com](http://www.greenbuildingfc.com)

U.S. Green Building Consortium [www.usgbc.org](http://www.usgbc.org)

## **Chapter Six—Hedge Funds**

### ***Examples of Responsible Hedge Fund Investments***

Ardley Partners [www.ardsley.com](http://www.ardsley.com)

GLG Partners European Equity Fund [www.glgpartners.com](http://www.glgpartners.com)

Good Steward Fund [www.highlandassoc.com](http://www.highlandassoc.com)

Winslow Management Company [www.winslowgreen.com](http://www.winslowgreen.com)

## **Chapter Seven—Commodities**

### ***Research and Advocacy Organizations***

Chicago Climate Exchange [www.chicagoclimatex.com](http://www.chicagoclimatex.com)

European Climate Exchange [www.europeanclimateexchange.com](http://www.europeanclimateexchange.com)

Forest Stewardship Council [www.fscus.org](http://www.fscus.org)

## Chapter Eight—Note on Emerging Markets

### *Examples of Responsible Investment Opportunities*

Dexia Micro-Credit Fund [www.dexia.com/e/discover/sustainable\\_funds2.php](http://www.dexia.com/e/discover/sustainable_funds2.php)

E+Co. [www.eandco.net](http://www.eandco.net)

Rio Bravo Investimentos [www.riobravo.com.br](http://www.riobravo.com.br)

### *Research and Advocacy Organizations*

Consultative Group to Assist the Poor (CGAP) [www.cgap.org](http://www.cgap.org)

The Microfinance Gateway [www.microfinancegateway.org](http://www.microfinancegateway.org)

### *Further Reading*

UNEP FI. *Banking on Value: A New Approach to Credit Risk*. New York: United Nations Environment Program Financial Initiative, 2007. [www.unepfi.org/fileadmin/documents/banking\\_on\\_value.pdf](http://www.unepfi.org/fileadmin/documents/banking_on_value.pdf)

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**The Boston College Center for Corporate Citizenship** is a membership-based research organization associated with the Carroll School of Management. It is committed to helping business leverage its social, economic and human assets to ensure both its success and a more just and sustainable world. As a leading resource on corporate citizenship, The Center works with global corporations to help them define, plan and operationalize their corporate citizenship. Through the power of research, executive education and the insights of its 350 corporate members, The Center creates knowledge, value and demand for corporate citizenship.

The Center offers publications including a newsletter, research reports, and white papers; executive education, including a Certificate program; events that include an annual conference, round-tables and regional meetings; peer-to-peer learning forums and a corporate membership program. [www.bcccc.net](http://www.bcccc.net)

**The Institute for Responsible Investment**, an affiliate of the Boston College Center for Corporate Citizenship works with investors, corporations, public sector organizations, and research institutes to coordinate thinking and actions around issues of strategic importance to long-term wealth creation for shareholders and society. [www.bcccc.net/responsibleinvestment](http://www.bcccc.net/responsibleinvestment)

**The F.B. Heron Foundation**, based in New York City, is a private philanthropic institution that makes grants to and investments in organizations with a track record of building wealth in low-income communities in the United States. Heron's mission is helping people and communities to help themselves.

Created in 1992, the Foundation supports community-based organizations that can demonstrate tangible results in promoting one or more of the following wealth-creation strategies for low-income families and communities:

- Advancing home ownership;
- Supporting enterprise development;
- Increasing access to capital; and
- Reducing barriers to full participation in the economy by providing quality child care.

As of December 2006, Heron had \$308 million in assets, a \$74 million portfolio of mission-related investments and an annual grantmaking budget of \$10 million. [www.fbheron.org](http://www.fbheron.org)

**EUROSIF**, the European Social Investment Forum, is the pan-European stakeholder network whose mission is to address sustainability through the financial markets. Eurosif works at the pan-European level as a partnership of the national Social Investment Forums (SIFs) and with the support and involvement of its member affiliates. Recognized as the premier European forum for sustainable investment, Eurosif's member affiliates are drawn from leading pension funds, asset managers, NGO's, trade unions, academic institutes and research providers, together representing assets totaling over 600bn. The key benefits that Eurosif affiliate members receive include EU interfacing, SRI information and European wide initiatives that integrate SRI and Corporate Governance issues into the financial services sector. The full list of Eurosif Member Affiliates is listed on the web site. [www.eurosif.org](http://www.eurosif.org)

**The Social Investment Forum** is the national U.S. non profit membership association dedicated to advancing the concept, practice and growth of socially and environmentally responsible investing. Our members integrate environmental, social and governance factors into their investment decisions and the Forum provides programs and resources to advance this work. The Forum membership includes hundreds of social investment practitioners and institutions including financial professionals , analysts, portfolio managers, banks, mutual funds, researchers, foundations, community development organizations and public educators. [www.socialinvest.org](http://www.socialinvest.org)



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# Handbook on Responsible Investment Across Asset Classes



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