CONSULTANTS, OCIOS LOOK TO MAKE MORE IMPACT IN ESG MARKET

BY KELLY CARROLL AND LINDSAY SAIENNI | JUNE 23, 2016

A growing number of investment consultants are integrating environmental, social and governance and impact metrics into their manager research processes in recognition of a growing interest from institutional clients.

Consultants are focusing on implementing enhanced research frameworks to assess the risks and opportunities presented by impact and ESG factors at a time when investors plan to increase impact investment commitments by 16% and the number of deals by 55%, according to 2015 data from the *Annual Impact Investor Survey* by the Global Impact Investor Network.

Investors committed $15.2 billion to 7,551 impact investments in 2015, which included ESG and socially responsible investments, GIIN said.

2015/16 Impact Investment Deal Flow Reported By Institutions

	2015 Reported		2016 Planned	
	Number of deals	Capital committed (USD millions)	Number of deals	Capital to be committed (USD millions)
Mean	48	97	75	113
Median	9	12	10	18
Sum	7,551	15,231	11,722	17,723

Above: Figures represent number and size of investments made and targeted. Source: GIIN

The consulting space has been paying close attention to climate change, as it has the potential to materially impact the economy and poses a new risk that institutions such as foundations and endowments may not be necessarily paying close attention to at this point.

Wilshire Consulting and Pavilion Advisory Group are among the consulting firms that have recently announced new initiatives as part of their ongoing efforts to integrate ESG factors into their manager research processes.

For Wilshire, the most recent initiative is its recently announced *ClimateLens* program, a strategic plan for investors to address climate change and decrease exposure through environmental investments. The program aims to provide education and investment resources to clients considering impact-related changes to their portfolios, while Pavilion announced that it would be putting more resources toward ESG-related research as part of its manager due diligence processes, officials from the firms said.

Wilshire President Andrew Junkin said in a recent interview that the firm's work to address climate change comes as he has seen the demand grow for ESG investing across client types, and believes that all investors should assess ESG-related risk factors within their portfolios.

"This is a significant enough, long-lasting risk in the current market environment that we feel like it needs to be addressed. Just like investors should consider the risk of rising interest rates or the risk of another equity market decline, they need to go through a process of understanding it, planning around it and making changes to mitigate it," he said.

Education is the first step with *ClimateLens*, Junkin said, adding that it is important to get everyone–particularly those in governance roles–on the same page because it is a broad, technical area that requires a great

GIIN's full Annual Impact Investor Survey can be found on its website.

deal of knowledge.

The second component for investors in the program is assessment, according to Wilshire. Investors will need to review their investment risk exposure in the context of their objectives and organizational capacity, which will include an analysis of governance and policies, asset allocation, manager selection, engagement and carbon footprinting.

"There will be pockets of these risks in almost every asset class. I think that you'll see debt and equity instruments and real estate impacted in varying degrees across the capital spectrum depending on what industries they're in, depending on where they're located, and what the regulations are doing to their business models. It will absolutely be across the capital spectrum," Junkin said.

Despite a discernible growth in discussion and interest in the ESG market, nonprofits are still slow to adopt the principles into their portfolios, investment consultant NEPC said in a survey published in May.

Some institutions, such as New York University, Cornell University and Stanford University, have decided against divesting their endowments from fossil fuels, pitting the one side of the argument that says there would be a negative impact on investment returns against the other contending that the positive social impact would equal or outweigh the performance of non-ESG assets over the long-term.

However, 35% of the institutions that decided against divesting would consider those investments in the future and 50% said they need education on the impact of the approach, NEPC said.

Even with education, Junkin noted that at the end of the day, the decision to make investment changes related to ESG or impact is different for every institution.

"Some clients may go through the process and decide not to institute most changes. Some clients may go through the process and decide that given their organization, their board, the nature of their investment pool and the cash requirements from it, whether it's a pension plan or a foundation or endowment, that it may decide climate risk is a risk they want to try to mitigate. In those cases, it will be very client specific to how it's mitigated," Junkin said.

Investors that decide to implement the *ClimateLens* program will have to take into account their investment policies, asset allocation, risk management, governance and operations and how that could be better managed for future exposure to mitigate ESG risks and capture opportunities, Junkin said.

After the planning stages, the goal is for investors to implement their mission investment decision-making framework, making sure to remain aware of the risk-return targets they've put in place, Junkin said.

The implementation stage will include investment policy modification in order to reflect climate policy as well as portfolio restructuring to hedge, reduce or eliminate exposure to carbon emissions and other climate factors, in addition to the creation of a climate-sensitive manager selection process, climate change risk-disclosure reporting, a carbon strategy analysis, and specific allocations to public or private environmental investments, according to Wilshire.

The ClimateLens program is designed to help clients understand and make informed decisions about the risks and opportunities associated with climate change, Junkin said. When an investor decides to exercise risk management within the space, Wilshire will execute client-specific climate change-related actions that calibrate the portfolio to desired risk-return targets.

Andrew Junkin

"Investors' primary concern is let's make sure that our returns are good, but let's try to understand this risk and if possible, mitigate it without impacting the expected return. Secondarily, now that we've addressed the risk, how can we profit from the investments," Junkin said.

For Pavilion, integrating ESG considerations into their manager research processes comes in response to the growing percentage of interest in ESG and related impact investments. Pavilion recently announced the signing of the United Nations-supported Principles for Responsible Investment, which is an international network of investors committed to incorporating the UN principles for ESG issues into their investment practices.

Michael McMurray, a senior consultant for Pavilion, indicated that while interest from his clients in ESG is not overwhelming at this point, the firm has already integrated it into their current manager research process in preparation for what they believe is a growing interest.

"Every time we interview a manager we now ask what they're doing on the ESG front – how they're looking at issues and implementing it," McMurray said. "We now include a section on ESG issues in our reports if a client asks for it, and we're reporting to clients on a quarterly basis on how their managers are doing."

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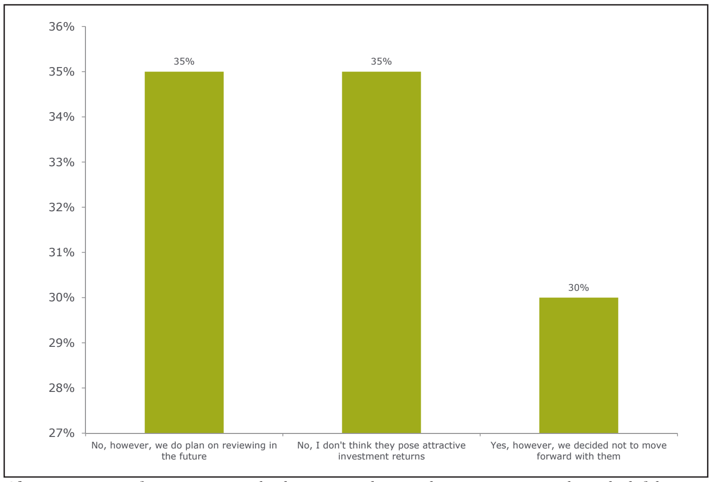
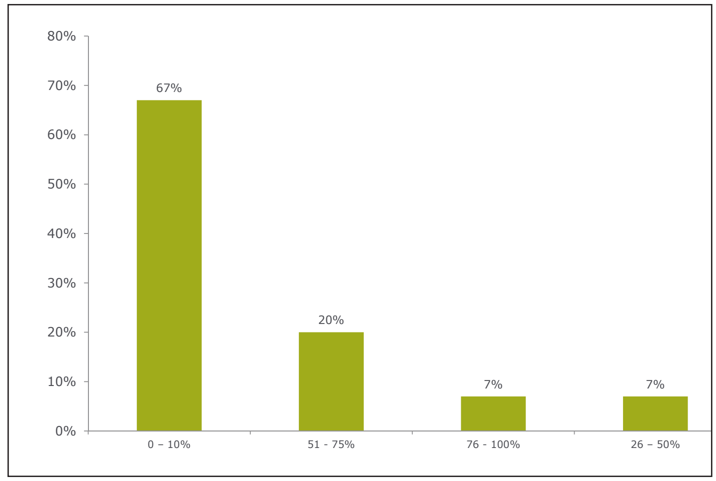
Further information on NEPC's impact survey and Wilshire's ClimateLens program can be found on the firms' websites.





Above: Responses from institutions that have not implemented impact strategies when asked if they had considered vehicles. **Above Right**: Responses from institutions when asked how much they have allocated to impact investments after implementing programs.

Source: NEPC Q1 Endowment & Foundation Survey

Pavilion, along with many of the investment managers it works with, is increasingly eyeing the risks involved with companies that don't meet their standards during their respective research processes.

"It's pretty difficult to find a manager that doesn't cover ESG issues at all, as headline risk is becoming much more important to them – climate change and supply chain being two examples," McMurray said. "Of the roughly 1,000 managers that have signed [the United Nations Principles for Responsible Investment], a majority of them are doing what they've always done, with more focus on ESG as a source of risk."

Pavilion Alternatives Group has integrated ESG factors into their manager research and due diligence processes, the firms said.

"Assessing managers' ESG policies has always been an important part of our overall due diligence process. We also analyze how managers, specifically in the alternative asset market, integrate ESG factors into their investment processes and monitor ESG-related risks within their portfolios," President and Managing Director Donn Cox said, in a statement.

Michael McMurray

There are a handful of foundations, universities and state retirement plans that have recently made decisions to integrate ESG into their portfolios.

Most recently, the $29 billion State of Connecticut Retirement Plans and Trust Funds issued an RFP for a general investment consultant wherein the plan noted that the firm will be responsible for looking over the ESG factors of each money manager, as reported in *NPNews* sister publication fin|daily.

Specifically, in the scope of services for money manager research, the plan requires evaluation of each manager's ESG capability and performance and also requests an annual report assessing ESG performance of existing money managers including "an evaluation of a manager's utilization of ESG factors in its investment process as a metric based upon a questionnaire from the Office of the Treasurer," according to the RFP.

In December, the University of Massachusetts Foundation announced plans to divest its endowment, valued at approximately $770 million, from direct investment in coal companies and sought to manage the endowment in alignment with ESG principles and moved toward an ESG-style approach.

On June 15, the university's board of trustees endorsed the foundation's decision to divest its endowment from direct holdings in fossil fuels. Chairman of the UMass Board of Trustees, Victor Woolridge, who also serves on the UMass Foundation board, said the endowment had direct holdings in fossil fuels in the vicinity of $5 million.

In the same vein, last summer the Ball State University Foundation approved the pursuit of an alternative investment portfolio within its endowment pool that adopts ESG strategies. To do so, the foundation asked its managers and consultants to incorporate ESG investment strategies.

Outsourced CIOs Addressing ESG

The ESG and impact investment space has also seen a rise in interest and implementation from outsourced cios, with Perella Weinberg Partners and Hirtle Callaghan & Co. among the firms launching strategies in recent years to address client demand.

Perella Weinberg's Agility team, which provides outsourced cio services to clients that include foundations and endowments, launched a global long only impact strategy on Jan. 1 that broadly addresses issues related to sustainability as institutions continue to reassess how to align their missions with investments outside of program-related assets, Director Jameela Pedicini said.

The strategy is comprised of underlying investment managers focused on holding companies positioned to capital-

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ize on sustainability-related trends and create by contributing towards a low carbon economy, according to Pedicini.

A growing amount of macro issues surrounding evolving sustainability challenges, such as climate change, resource scarcity and shifting demographics, among other issues, have the potential to affect business profitability, putting the strategy in position to take advantage of an evident shift in how long-term value can be created in a changing investment landscape, she said.

Hirtle Callaghan announced last July the launch of a new global equity portfolio that incorporated ESG considerations, while Perella Weinberg has been implementing ESG strategies and research into its Agility platform, which provides outsourced cio services for foundations and endowments.

In a recent interview with Hirtle Callaghan’s ESG Investment Specialist Garrett Wilson, he explained the firm’s view on ESG and impact investing.

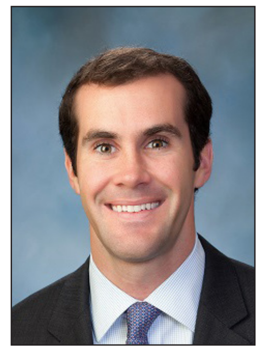
“We think about it in three buckets: SRI or negative screening, impact investing which is targeting a specific environmental or social benefit, and ESG which integrates ESG factors into the investment process,” he said.

Hirtle Callaghan decided to pursue ESG over SRI and impact investing because it served a purpose that the other two did not. “There’s a difficulty to come to an agreement on how to represent [the clients’] social concerns, and ESG can help solve that because it looks at everything holistically and across all sectors,” Wilson said.

As for why the firm decided to go into the space initially, he noted that it was a response to rising interest.

“We decided this is something that we wanted to do due to continued interest in the space. More and more people recognize that this is an important function. As an OCIO, if you don’t have these capabilities, then you’re not meeting the needs and wants of your clients,” Wilson said.

While the response can be seen as just an instinctual reaction to the current trend in the market, Wilson pointed out that implementing ESG can benefit everyone in the long run. “It could very well be a proxy for better run companies. The more information you analyze, the better,” Wilson said.



Garrett Wilson

In response to McMurray’s view that it is difficult to find a manager that does not integrate ESG into their portfolio, Wilson said that it’s important to go below the surface answer of a manager that simply says they have integrated, but has not begun the process beyond that.

“It’s important to dig deeper – it’s still the minority of managers that embed ESG issues into their process. You have to ask the tough questions and find out how they execute that process,” Wilson said.

While efforts in integrating ESG into portfolios and due diligence practices are nothing new, the understanding of the risk factors and overall performance has led many managers and consultants to make the change.

“More data has become available which has provided strong information on the benefits of assessing ESG risks and opportunities on top of traditional financial analysis. We’ve also seen headline examples over the last few years where an ESG related event has had a material impact, both negatively and positively, on a company or underlying investment,” he said.