The Evolution of Responsible Investment Consulting Workshop State of the Union/State of the Field

Institute for Responsible Investment

BOSTON COLLEGE
CARROLL SCHOOL OF MANAGEMENT
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Background

On April 2, 2009 at a daylong meeting titled "The Evolution of Responsible Investment Consulting," a group of 35 investment consultants, asset managers and other stakeholders from across the country gathered at Boston College to discuss the state of responsible investing consulting and the potential for the emergence of responsible investment as an investment consulting discipline.[1] Despite investment consultants' desire to satisfy an increasing client-driven demand, a fully developed discipline of responsible investment consulting across different types of institutions has yet to emerge.

The consultants and asset managers in attendance were all engaged in broadly serving their clients on responsible investing strategies and investment opportunities. They included representatives ranging from boutique firms focused on mission and impact investing to larger consulting firms whose representatives either came from an internally established responsible investment team, or had clients with an interest in the field, but lacked a team solely dedicated to responsible investment.

The current state of play

The conversation on the state of the market today suggested that the field of responsible investment does not to date have a common language or clearly defined metrics, but is characterized by an often disparate but overlapping vocabulary incorporating investment goals, social and environmental impact, extra-financial reporting, and financial return objectives. The motivations driving client interest in responsible investment can include the following:

1) Belief that investments in organizations that practice sustainability or operate according to best practices in the areas of environment, society and governance issues are strategically well-positioned to outperform financially over the long term;

2) Desire by investors to achieve social and environmental impact through market rate investments, shareholder advocacy and engagement and, for some, through below-market rate investments ;

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[1]The Boston College Institute for Responsible Investment convened the meeting based on the premise that there are an increasing number of investors – institutional and individual – who seek investment value, and social, environmental and governance (ESG) benefits, through the incorporation of ESG information into their investment decisions, referred to as responsible investing.

3) Desire to find innovative investment products that capitalize on social and environmental macrotrends;

4) Ability to eliminate regulatory and reputational risk

5) Desire to align investment holdings with values, and to use shareholder rights to engage publicly traded corporations on key environmental, social, and governance issues.

These motivations are frequently associated with specific kinds of investors such as institutional investors trying to maximize long-term returns, foundations seeking mission impact, high net worth individuals pursuing innovation around macrotrends, or public pension funds seeking economically targeted investments that create collateral social and environmental benefits. As noted, these motivations can overlap, and can incorporate multiple goals. For instance, there are Taft-Hartley pension funds that are active shareholders, pursue green opportunities, and also incorporate labor standards into their alternative asset management strategies.

What emerged from the conversation was a sense of family resemblance more than a unified field. Attendees saw themselves as fellow members of a growing discipline of responsible investment, but a discipline that is likely to grow organically over time, through the interaction of a variety of investors, investment strategies, and goals. Many agreed that responsible investing can change through enhanced access to ESG analysis. The information that is currently available, however, is not enough.

The challenge of defining responsible investments

For each of the motivations noted above, the consultants' role is to determine if there are products that meet their clients' specific goal or combination of goals, to advise their clients on how those products should be incorporated into an overall investment strategy, and to provide benchmarking and evaluation of the performance of the products. Thus far, the consultants' approaches to responsible investing seem to stem from client-specific direction. Among the most immediate challenges that consultants face is how to identify, categorize and measure the investments that are positioned as responsible.

Consultants whose clients view environmental, societal and governance (ESG) analysis as a matter of financial risk and opportunity, may adopt the following approaches:

- Evaluation of how investment companies or products go about integrating ESG analysis into their financial analysis investment framework and shareholder advocacy.

- Identification of products that address key themes understood to be material financial concerns such as climate, water and human rights

For clients who seek to create and measure social and environmental impact, two contemporary practices emerged:

- Evaluation of investment opportunities that present ESG benefits on traditional financial risk and performance criteria only, without independently evaluating ESG benefits

- Evaluation of investment opportunities' ESG benefits and screening potential investments for mission-oriented impacts as well as applying traditional metrics for financial viability.

Several attendees used a type of "you-know-it-when-you-see-it" approach to responsible investments. Many noted that, on a client-specific basis, they are incorporating additional due diligence into their traditional reviews that attempt to determine the relative commitment of investment managers to ESG analysis and

social impact reporting. However, "patch work" due diligence, the lack of consistent standards, and the relative newness of many responsible investment (RI) products have created issues of standardization, replication and scale

In addition, the old barriers to unifying the field of responsible investment still remain. Among these commonly cited challenges are 1) the lack of common language around responsible investment, 2) lack of confidence in research supporting the field, and 3) a need for understanding that there are many degrees of opportunity for the integration of RI into portfolio management -- that is, RI need not be an "all or nothing" undertaking. A pervasive view that RI is always a below-market rate undertaking is also a common misconception. One conclusion drawn was that the appropriate elements of a responsible investment discipline are more likely to emerge from the self-standardization of practices by the consultants themselves than from the amalgamation of client interests and demand from different sources.

Identifying responsible investments

Attendees uniformly affirmed that a relatively robust universe of RI products either available or coming to market now exists, even though no clear definitions of what constitutes RI products exist. It was also noted that the universe of products is not evenly distributed across either asset classes or issue areas. These loose category definitions, coupled with the varying RI goals, have led consultants to assemble anecdotal lists of RI products through colleagues, trade associations or other personal and professional networks.

Building a pipeline

One approach to addressing this absence of clear definition and lack of definitive data on RI product could be collaboration among practitioners in building a pipeline of responsible investment products that could be made publicly available. Such a pipeline could help to define what constitutes a responsible investment, could help to address the challenges of scale and replication, and could serve as an attractive repository for product manufacturers.

Furthermore, a publicly available catalog of RI products – housed in a non-competitive, public purpose entity – may help better define the field, add common language, and attract investors skeptical of the depth of offerings. However, such a database of RI products would still face substantial challenges, including those relating to standardization of collection and presentation, categorization and measurement of both intended and observed ESG effects, and potential liability

issues for the warehousing entity. An additional challenge faced by such a catalog, as well as by the industry as a whole, would be distinguishing between those investments that satisfy their stated RI goals, and those that simply incorporate RI marketing language without robust commitment to RI practices.

Ratings system and investment impact

To satisfy the challenge of measuring the RI impact, it was suggested that a standardized ratings system be collaboratively developed – housed in a neutral institution – that could be used to evaluate the social and environmental performance of investment products. This system would allow investors and their consultants to use third-party data to assure investors that their investments were achieving the social and environmental goals they seek.

The need for, and practicability of, such a system was a point of contention. "We know it when we see it" certainly will not serve as a long-term solution to the problem of the legitimacy of RI claims and amplitude of RI impact, especially if the demand for such products continues to grow. Consultants working primarily with mission investors concerned with specific social impacts did not necessarily agree that the lack of metrics or ratings was a major limiting factor. However, many felt the lack of objective metrics was hindering the development of RI among institutional clients. From another perspective, the challenge is not rating the ESG impact of investment products but enhancing information that would help investors to clarify their investment choices. Either way, no easy solution was seen to the problem of achieving comparability across heterogeneous mission goals that a ratings system would require.

For many attendees the issue of impact and ESG performance measurement proved easier to evaluate in alternative investment asset classes – especially private equity and real estate – than for public equities. This was true, in part, because of the more immediate and quantifiable impact measurements available for, say, real estate investments, for which issues such as geographic targeting to under served areas, job creation, affordable housing, energy and resource efficiency, and environmental impact are readily measurable.

Attendees also noted that a high degree of due diligence was implicit in non-public equity investments such as community loans or private equity, which allows for a more thorough, if not always more quantifiable, assessment of managements' commitments to ESG issues. Public equity products on the other hand proved to be a more difficult asset class for RI consultants to evaluate, in part because the impact measuring tools for alternative investment – accounts of jobs

created, investments targeted to under served areas, carbon emissions reduced, diversity of investment managers -- do not necessarily lend themselves easily to integration into fundamental analysis or manager evaluation.

It was noted that particular difficulties lie in the development of ways to evaluate the processes of ESG investing by managers, and benchmarking the non-financial performance of these relatively new products. Attendees also noted that shareholder advocacy, though its impacts are not easy to quantify, is for many investors an especially important part of evaluating RI products and the commitment of managers to the field.

It is likely that over time investors will become unwilling to invest in products that are unable to demonstrate and document their impact, and institutional investors seeking to reduce exposure to ESG risk, will no longer be willing to rely on manager claims alone. While customized systems for defining and tracking responsible investment performance create higher costs for investors and managers alike, it may be that without a standardized approach to both questions, the responsible investment field will not mature and allow for the scalability and replicability that consultants tend to seek.

Asset allocation strategies

For many consultants, their fundamental role is to work with their clients to develop asset allocation strategies and to recommend, within those allocations, managers best suited to meet their clients' goals. Traditionally, asset allocation strategies developed between consultants and clients do not allow for ESG considerations to be applied. One key question, therefore, is: how does responsible investment relate to asset allocation strategies and how will the evolution of responsible investment affect those strategies in the future?

Consideration of financial risk and reward characteristics of various asset classes is the current dominant paradigm for asset allocation. Only after asset allocation strategies have been determined by these methods are the responsible investment fund managers and products chosen to fill out asset classes appropriately. For example, a climate-weighted fixed income or equities fund would take the place of a comparable traditional fund within the overall allocation strategy.

This model poses a number of problems for RI investments. To begin with, responsible investment products in this still-emerging field may be inappropri-

ately eliminated from consideration due to their relatively short track records. This would be especially unfortunate given that some consultants have seen fit to recommend equally new and untested mainstream investment products that have no ESG profile. The recent history of credit default swaps and collateralized debt obligations is a cautionary tale.

Furthermore, this asset allocation model does not incorporate the societal and environmental benefits and risk-mitigation strategies that are part of the RI approach and relevant in different ways when implemented across all asset classes. Responsible investment explicitly addresses systemic extra-financial benefits and risks that were formerly thought to be tangential, but the tools to assess these factors have not yet been fully developed. Certain research products are starting to address this issue, but a variety of challenges, including the mismatch in time horizons, remain to be overcome.

Investors seeking to maximize financial returns, and match them to their tolerance for risk, use assessments of the risk/reward characteristics of asset classes to set their asset allocation. However, this approach may not be appropriate when it comes to responsible investment. Important issues such as climate change might call for a different asset allocation or, if an investor's goal is to optimize both financial return and mission impact, a new framework – one that takes mission impact into account in the construction of entire portfolios, and not just allocation within traditional frameworks – may be necessary. In sum, if responsible investment has not yet had major impact on traditional asset allocation strategies, its implications for a variety of investors and investment goals have at least the potential to radically revise how consultants take on this fundamental task.

Moving forward

The conversation at this meeting made it apparent that a field of responsible investment consulting is one that is emerging, but that formal processes, coordinated industry practices, and a coherent account of what RI means in the practice of investment consulting have yet to be clarified, systematized and standardized. At the moment, robust growth of a relatively ad hoc discipline can be seen. However, "prudence is process," as one attendee noted, and without a more coherent understanding of what RI process entails, consultants will be hampered in their ability to communicate with their institutional and individual clients, investment fund managers and other stakeholders, and the field may be slower to come to scale.

Several ideas for follow up emerged:

- A sustained network of consultant practitioners may be a valuable way for consultants to determine the commonalities in their practice, and to find areas for collaboration where appropriate;

- Working groups on benchmarking, ratings and social impact, and related issues may offer useful analysis of key issues from the consulting perspective;

- Communication of the shared, public aspects of responsible investment consulting will be vital for growth of the field and contribute to publicizing it as a discipline;

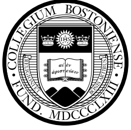
- An open-source catalog of responsible investment managers and products, across asset classes may help catalyze investments;

- Research into the experiences of asset owners, managers and consultants, with a community beyond just those who attended this first meeting, might expand on these initial impressions of the field, and clarify the opportunities for, and barriers to, the evolution of responsible investment consulting.

This initial conversation should help spur new research, network-building and collaboration among consultants and other stakeholders, and help shape this emerging field.

Institute for Responsible Investment

The Institute for Responsible Investment, a project of the Boston College Center for Corporate Citizenship, provides a platform for dialogue on fundamental issues and theories underlying responsible investing. Our work is meant to identify and promote market structures and investment activity that can best create long-term wealth creation for investors and society alike.



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