Sustainable Investment for Charitable Foundations

Topic of the month May 2016

Charitable foundations increasingly consider environmental, social and governance (ESG) criteria in their investment decisions. With this approach, they not only accommodate the increasing pressure to consider sustainability criteria in their wealth management, it also allows them to align their investment strategy with their mission and to improve their portfolio's risk/return profile.

Pressure on charitable foundations due to regulation and volatile markets

Traditionally, charitable foundations' primary concern has been to realize their mission effectively and efficiently. However, the sector is currently going through a period of change. Charitable foundations are increasingly under public scrutiny, facing growing regulatory requirements regarding the foundation's management and governance on the one hand, and increasing public demand for transparency on the other.

More and more regulators around the world are recommending foundations to align their investment strategy with their mission. In Switzerland, for example, investment management is a key feature of the Swiss Foundation Code, a framework that provides charitable foundations with guidance on various topics related to foundation management. In its latest edition the Code highly recommends the alignment of the foundation's investment strategy with its mission as well as adherence to ESG criteria.[1] In the UK, the Charity Commission recommends trustees to consider ESG factors in their investment decisions, in order to avoid investment conflicts with the foundation's mission and the risk of incurring reputational damage.[2] In the US, the Internal Revenue Service (IRS) mandates private foundations to make an annual 5 percent distribution from their assets. This also includes program-related investments, which advance the foundation's mission.[3]

An additional challenge that charitable foundations face is the continuing low-interest environment. In the wake of the financial crisis it has become increasingly difficult to generate appealing returns.

In light of these trends, we see charitable foundations therefore expanding their focus from mere charitable activities to implementing an investment approach that not only generates financial returns but also supports their mission and considers sustainability criteria.

How charitable foundations can approach sustainable investment

There are different ways for charitable foundations to approach sustainable investment. These range from avoiding investments in companies that operate in a way that may be harmful to the foundation's mission (negative screening) to investing in companies and solutions that reflect the foundation's values (positive screening). To screen and construct a sustainable portfolio, a combination of sustainable investment approaches can be applied.

The *exclusion approach* avoids investments in companies linked to certain controversial activities (e.g. weapons or nuclear energy), the effects of which may undermine the foundation's mission. The *norm-based approach* tackles reputational risk in areas that are controversial from an ESG perspective and the screening process hence focuses on whether a company is involved in ongoing controversies (e.g. labor rights issues) that constitute material or reputational risks.

This year, for example, the Rockefeller Family Fund (RFF) announced its decision to withdraw all investments in fossil fuel companies. Even though the family fortune's origins lie in the oil industry, today the RFF states that, "there is no sane rationale for companies to continue to explore for new sources of hydrocarbons"[4]. The fund will seek suitable alternatives in sustainable investing, an area which is "dynamic and growing and we are confident that a variety of options will soon emerge for mid-sized endowments such as ours"[4].

The *best-in-class approach* identifies companies that perform well in terms of ESG criteria within a peer group by assessing their ability to successfully manage ESG issues such as carbon emissions. Last but not least, *thematic investments* provide a good opportunity to strengthen mission-related themes and support solutions that address sustainability-related topics, such as clean energy or education. Impact investment, for example, can be applied as a form of alternative investment that further supports the mission through targeted investments, while at the same time offering attractive diversification benefits in addition to the social impact. Another example are green real estate investments, through which a portfolio's carbon footprint can be improved. With climate change representing the major global challenge of our time, sustainable real estate could make a major difference to this pressing issue as approximately one third of global CO_2 emissions stem from the real estate sector.

Benefits for charitable foundations

A sustainable investment approach can benefit charitable foundations in many respects.

By investing sustainably, foundations will avoid investments that present a conflict with their mission and bear substantial reputational risks. It allows them to support their mission through targeted investments that generate a positive (mission-related) impact alongside financial returns. It also allows the foundation to take a more comprehensive view and improve its portfolio's long-term risk/return profile by incorporating sustainability-related considerations such as ESG-related risks and opportunities into its investment management. It does so in a very practical manner when looking at impact investment building blocks, which usually show low correlation with traditional investment classes. Additionally – against the backdrop of the low-interest environment – sustainable real estate has the potential to provide economic returns as well as environmental returns while improving the carbon footprint of a portfolio.

The different approaches to sustainable investment can be combined to create a customized portfolio, which corresponds to the foundation's mission and objectives – and ultimately to regulatory guidelines and recommendations as well as the public demand for more transparency.

Philanthropy & Sustainable Investment at Credit Suisse

Client demand for investments that incorporate economic, environmental and social aspects is growing steadily. At Credit Suisse, we offer a broad range of products and services that provide investors access to opportunities to create impact. Our Philanthropy and Sustainable Investment specialists provide advice, products and tailored solutions to clients who want to integrate personal values as well as social and environmental objectives into their wealth management. This may include, for example, setting up philanthropic structures, investing in products in the areas of impact investment and microfinance, green real estate or integrating sustainability criteria into their investment portfolios. At the end of 2015, Credit Suisse's assets invested according to sustainability criteria totaled nearly CHF 18 billion.

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Footnote and References:

1) *See also recommendation 24, 25 and 28 of the Swiss Foundation Code 2015*
2) *See also Charities and investment matters: a guide for trustees (2014) of the Charity Commission* *https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/476012/cc14_lowink.pdf*
3) *See also IRS: https://www.irs.gov/Charities-&-Non-Profits/Private-Foundations/Qualifying-Distributions-In-General*
4) *See also Rockefeller Family Fund: http://www.rffund.org/divestment*