ENVIRONMENTAL, SOCIAL, AND GOVERNANCE INVESTMENT PRINCIPLES

Aligning organizational mission to Investment Policy Statements and Responsible Investment policies

Introduction

In recent years, the prevalence of Environmental, Social, and Governance (ESG) investing has accelerated, driving increased stakeholder awareness, greater availability of investment strategies promoting investor values alignment, and increased investment options that incorporate strong ESG practices across both the investment and stewardship processes. These trends typically align with Endowment and Foundation (E&F) investors' objectives as they look to integrate their organizational mission into their investment portfolio objectives. While E&F investors recognize the benefit of this integration, it is often not clear how to operationalize their mission into real, actionable investment decisions and portfolio outcomes. This can result in the development of an Investment Policy Statement (IPS) and Responsible Investment (RI) policy that can be difficult to implement and create challenges for the organization in the investment selection and monitoring phases. This paper will explore key components of the IPS, how ESG factors can be relevant, and effective strategies to optimize mission aligned outcomes.

What is ESG?

ESG is a set of criteria used to evaluate companies and investments from a sustainability perspective. The environmental criterion assesses how a company performs as a steward of the natural environment and attempts to uncover how a company manages the risks and opportunities presented by environmental factors. The social criterion examines the company's impact on its workforce and broader society and the risks and opportunities presented with how the company manages these considerations. The governance criterion focuses on how the company is governed and managed and is a vital part in establishing how the company develops and implements effective policies to manage the environmental and social factors.

Environmental factors

- Carbon footprint
- Climate risk
- Pollution and waste management
- Natural resource use

Social factors

- Labour practices
- Human rights
- Community engagement
- Diversity and inclusion

Governance factors

- Board structure
- Executive compensation
- Shareholder rights
- Reporting and transparency

Together, ESG factors provide a holistic view of a company's sustainability and ethical practices, and help investors develop an understanding of the non-financial risks and opportunities that may impact a company's long-term performance. While the primary use case for ESG considerations is to make more informed investment decisions in the pursuit of better risk adjusted returns, they also present an opportunity for investors to use these factors to better align their investment portfolios with their organizational values, while still meeting their financial goals. To better understand how ESG factors can be implemented in portfolio decision making, it is important to understand the various forms of ESG investing in the market today.

ESG integration

ESG integration refers to the process of incorporating ESG factors into the investment decision-making process. It involves analyzing and evaluating material non-financial issues that may affect a company's financial performance over the long term and considering these factors alongside traditional financial analysis.

The industry has rapidly evolved in the development of ESG integration practices, resulting in many different approaches to integrating these factors into investment decision making. These can range from establishing issuer ratings on an absolute or sector relative basis, to the identification of material ESG risks and opportunities and pricing those into financial models, to placing a focus on active ownership (engagement and proxy voting) with portfolio companies.

The ESG integration practices of an investment manager are becoming increasingly important for investors. As the market matures and capital markets develop an increased awareness of how these factors can impact an issuer's performance, a manager's ESG integration process is increasingly relevant to its ability to deliver long term risk adjusted returns for investors. The incorporation of ESG factors into investment decision making helps investors identify companies that better positioned to manage ESG risks and opportunities, and potentially generate better long term returns for investors. As a result, the scope of investment manager due diligence has rapidly evolved to include an assessment of a manager's ESG framework in order to assess both its efficacy and its alignment with investor objectives.

Socially Responsible Investing (SRI)

SRI is an investment approach that considers not only financial returns but also the social and environmental impact of the companies in which one invests. It involves screening investments based on sustainability criteria, such as human rights, labor practices, environmental impact, or corporate governance, and avoiding companies that engage in practices that conflict with the pre-determined criteria.

The approach to screening can take various forms, depending on the specific investment strategy and approach. Negative screening is an approach that involves excluding companies that engage in certain activities deemed harmful, such as tobacco, firearms, or fossil fuels. It can also include screening companies that do not meet specific criteria established by global norms, for example eliminating companies that have UN Global Compact violations from the investible universe. Positive screening involves selecting companies that are actively engaged in activities that promote social and environmental values, such as companies aligned with Net Zero by 2050 or those with a Progressive Aboriginal Relations certification.

SRI investing may also include strong approaches to active ownership, where investors engage with companies to encourage them to improve on their sustainability practices. This approach is often resource intensive and requires strong reporting and accountability measures to ensure objectives are being stewarded through the engagement and voting process.

While the criteria behind the inclusions, exclusions, or stewardship objectives can vary, the intent of these screening strategies is generally consistent – to create a portfolio of companies that has no exposure to a particular business activity and/or to facilitate achieving outcomes that align with the investor's values.

Sustainable thematic investing

Thematic investing involves allocating to sustainable themes that have a material impact on society. In some cases, themes can have significant structural tailwinds that improve their long-term return potential, but also come with higher degrees of risk. Examples of investment themes include sustainable agriculture, clean energy, and green property.

There are several ways that investors can allocate to one or more themes, with the most common being specific thematic funds focused on one area, or broad thematic funds that encompass multiple areas. In both cases, the investment manager should perform an assessment of how exposed a particular company is to any theme before deeming it eligible for inclusion into a portfolio.

Impact investing

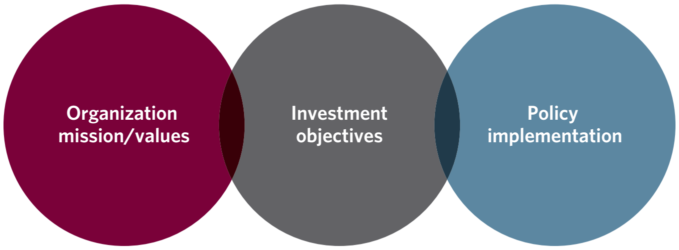
Impact investing is an emerging investment approach that seeks to generate positive social or environmental impact alongside financial returns. Unlike traditional investing, where the primary focus is on financial returns, impact investing places equal weight on the social or environmental outcomes of investments. Impact investing aims to address specific challenges, such as poverty, climate change, or inequality, while still generating financial returns for investors. Unlike SRI investing, impact investing seeks to affect change rather than simple alignment with a subset of values. For example, in the case of climate investing, an impact strategy would look to generate real measurable reductions of CO2 emissions through targeted investments in low carbon technologies, rather than portfolio alignment with net zero.

A major challenge of impact investing is the measurement of the social or environmental impact of the investments. Impact investors use various metrics and frameworks to track and report on the non-financial outcomes generated by an investment portfolio. Investment managers and industry associations are working towards creating better frameworks to assess the impact of public market investments (including a recently released framework issued by the Global Impact Investing Network (GIIN)), however it remains challenging to measure the direct impact an investor is making by exchanging public shares. Impact investing is typically more suited to private markets, where the investment can be more directly tied to an outcome.

Despite its challenges, impact investing remains an emerging asset class that is particularly well suited to achieving non-financial objectives. As the space matures, there is an expectation that more solutions will come to market, providing E&F investors with more flexibility and choice on how to best integrate their organizational values directly into portfolio outcomes.

Mission alignment and stakeholder engagement

The first step in integrating ESG investment principles is developing a set of goals and objectives that are translated into the IPS and RI policy in the form of investment objectives. This can be executed by converting a pre-established organizational mission into clearly defined investment constraints or opportunities. Internal review can be conducted to assess the relevant criteria the best reflect the mission of the organization, and in some cases, It may be deemed important to gather input via stakeholder engagement. While this is viewed as best practice in establishing a fulsome view of the relevant issues, it adds significantly to both cost and implementation time. Organizations without pre-established mission statements may feel the need to gather stakeholder input more than those with defined social and environmental goals and objectives. However, it may be more efficient to have the board or investment committee establish the key priorities with internal feedback rather than involving all organizational stakeholders. Once goals and objectives are established, the various sections of the IPS and RI policy will provide opportunities to reflect how they are to be implemented by the E&F's investment manager.



A foundation focused on supporting low income Canadians may identify workers' rights and fair wages as investment priorities. These strategic objectives are best suited for inclusion in an RI policy. It is important to identify the opportunity without being prescriptive in application. The investment manager selection process is where fulfillment should be evaluated against strategic objectives. This will ensure flexibility is provided to the investment committee in the selection process.

IPS Components and ESG alignment

In this section, we will cover the various components of a typical IPS and discuss the relevant ESG considerations to include within each section. Overall, our recommendation is to communicate expectations without being prescriptive. Your manager due diligence should guide fulfillment decisions rather than your IPS constraints.

Section	Scope	Relevant ESG considerations
Purpose and scope	Provides an overview and sets the tone for the guidelines to follow in the body of the document. Outlines the general objectives and fiduciary duty of committee members.	Outline the organizational mission and that the mission should receive equal consideration within application of the IPS. Highlight the importance of ESG considerations in the fiduciary duty of the committee.
Definition of duties	Defines the responsibilities of parties dedicated to investment decision making and oversight.	Articulate the ESG responsibilities of all involved parties.
Objectives	Outline the investment objectives with an outcome focused approach. Identify goals and constraints against market expectations and establish return and risk targets that account for organizational needs.	ESG considerations may impact liquidity, time horizon, and spending rate and should be an important input when establishing realistic expectations.
Strategic Asset Allocation	Establish the asset allocation guidelines for the portfolio based on objectives and appropriate time horizon and risk assumptions.	ESG considerations may have a material impact on sector and portfolio diversification. It is important to evaluate these impacts to establish an appropriately diversified asset allocation that will meet the goals and objectives of the organization.
Rebalancing	Define the rebalancing philosophy of the organization.	N/A
Liquidity policy	Liquidity is required to meet spending needs. Define appropriate cash levels and portfolio liquidity requirements.	Certain ESG investment strategies may carry significantly lower liquidity. This should be considered when establishing minimum requirements.
Spending policy	Establish a spending rate policy that provides a predictable steam of revenue to meet organizational goals while preserving capital.	N/A
Risk management	Define the level of risk the organization is willing to take and outline the important measures of risk to be considered.	Outline the importance of the integration of ESG risks and opportunities. Define systemic risks that are particularly relevant to the organization for consideration, for example climate change.
Monitoring and review	Establish expectations for regular monitoring and review of investment outcomes against objectives.	Develop expectations for the review of ESG and Responsible Investing guidelines and outcomes. Establish ongoing ESG focused reporting requirements.
Responsible investing	Includes guidance on the governance and incorporation of responsible investing in portfolio construction and decision making.	Identify who is responsible for oversight of responsible investing practices. Identify which ESG investing principles will be applied to portfolios.
Acknowledgement	Final statement of acknowledgement of the IPS	N/A

Purpose and scope

The purpose and scope section of the IPS is designed to set the tone and overarching expectations for the specific guidelines within the body of the policy. This is an opportunity to define the organization’s mission and establish an expectation that the investment portfolio aligns with that mission. In this section, it is typical to define the fiduciary duty of committee members and it is therefore important to acknowledge the relevance of ESG considerations in that duty. In cases where the Endowment or Foundation wishes to place greater importance on non-financial outcomes, this is an appropriate section to outline that expectation. It is appropriate to indicate the expectation for committee members to consider an investment decision’s financial and non-financial outcomes when making decisions in the best interest of the organization.

Definition of duties

When defining the responsibilities of relevant parties, it is important to include ESG considerations. Parties that may have ESG considerations within their defined roles include:

Role	ESG consideration(s)
Board of Trustees	Defining the organization’s mission and translating the mission into the ESG investment objectives.
Investment Committee	Implementing the ESG considerations outlined in the IPS. This includes ensuring alignment with ESG objectives and evaluating the strategy to achieve them within the selection and ongoing monitoring of investment managers or OCIO providers.
Consultant	Due diligence recommendations, including the evaluation of investment managers’ ability to adhere to the ESG objectives outlined in the IPS
OCIO provider and/or investment manager	It is important to ensure they assume the ESG objectives as part of their fiduciary duty. The Investment Management Agreement should include expectations around adherence to the organization’s IPS and RI policy.

Objectives

ESG considerations are dually important when establishing the objectives for the portfolio. It is important to adjust expectations based on any investment constraints or preferences to ensure alignment with risk and return expectations. This is also an opportunity to clearly state the ESG or non-financial objectives for the portfolio. While explicitly outlining these objectives may be better suited for the RI policy, it is important to clearly link portfolio objectives to the prioritization of the stated RI policy objectives.

Strategic Asset Allocation

Strategic asset allocation will be the guiding method upon which the portfolio will be designed. ESG considerations may have significant impacts to how the portfolio is constructed, and therefore should be considered within the asset allocation decision making process. Investment guidelines and constraints may have impacts on risk, return, and diversification that require consideration within this process. For example, an allocation to sustainable thematic investment solutions in private equity may introduce long holding periods and capital calls that add to the complexity of designing an appropriate asset allocation.

Example: Impacts of ESG investment decisions on Strategic Asset Allocation

Decisions	Divestment	Positive screening	Thematic/Impact
Definition	Exclusion of particular industries or companies based on predetermined criteria	Exposure to higher quality ESG issuers or global norms compliant companies	Exposure to sustainability opportunities or seeking to generate non-financial returns (typically via private markets)
Potential Impact(s)	Smaller investible universe; Increased tracking error versus broad benchmarks	Potential for unintended factor exposures	Liquidity reduction; potential capital calls; volatility impacts; portfolio construction implication
Recommendation(s)	Consider alternative asset classes or investment styles to compensate	Consider portfolio level factor tilts and/or adjustments to strategic asset mix to compensate	Ensure liquidity requirements can be met from other portfolio allocations; ability to service capital calls; adjustments to strategic asset mix to ensure appropriate diversification

Risk management

The risk management section of the IPS provides an opportunity to state beliefs as it relates to the incorporation of ESG factors within the investment process and systemic risks of particular importance to the stated mission. Acknowledgement of the relevance of these factors sets strong expectations for how risks are identified and integrated within the portfolio decision making process.

When assessing appropriate risk measurement, it is vital that flexibility is maintained for operationalizing the non-financial considerations laid out in the goals and objectives identified through the organization’s mission. If the investment portfolio will require exclusions or targeted ESG investments within the asset allocation, an allowance for greater tracking error should be permitted. For example, a fossil fuel free benchmark carries an expected tracking error to the S&P/TSX Composite Index of approximately 400bps. This could exhaust the limit on standard risk management language or provide the manager with limited flexibility in their investment decision making if the IPS guidelines do not allow for larger tracking error bands.

The other alternative is to establish more relevant benchmarking. Staying with the fossil fuel divestment example, fossil fuel free benchmarks could be selected in place of their broad market counterparts. This may create challenges in the search and fulfillment process, as managing a tracking error constrained portfolio requires the manager to have ownership of the stated benchmark. In cases where prospective or existing investment managers do not currently subscribe to the stated IPS benchmark, it is possible a significant number of managers would be unwilling to manage a portfolio to those constraints. It is recommended that the IPS maintain flexibility to maximize investment choice and allow the consultant or investment committee to evaluate the proposal from prospective investment managers and the merits of their fulfillment proposition.

Monitoring and review

The IPS should clearly articulate the importance of measuring the performance of the stated non-financial objectives. The monitoring and review section should establish the required cadence for regular reporting and outline which ESG characteristics are relevant for the investment committee to actively monitor. Portfolio characteristics should be assessed alongside stewardship reporting, including the progress associated with strategic priorities. This is an opportunity for the investment committee to assess the how the manager is tracking and measuring their success related to the objectives for change identified within the organization’s mission. It is also important to include the requirement to review and attest to the adherence of the organization’s RI policy at regular intervals. This will ensure that investment managers acknowledge and integrate the latest form of strategic ESG priorities for the organization. It will also provide an opportunity for regular dialogue on fulfillment to align expectations with investment and stewardship.

Responsible investment

This is where the organization lays out the approach to ESG and Responsible Investment that should be adhered to across the portfolio. It is our recommendation that this information should be housed in a separate RI policy. This allows the organization to regularly review the effectiveness of the policy in aligning the portfolio with the mission statement and make updates on this success or evolving organizational priorities. By creating a separate policy that requires regular review and attestation of adherence by the investment manager, the investment committee and board will not need to engage in regular review and negotiation with investment managers on the IPS and IMA.

For more information, the PRI provides resources to assist asset owners in creating a robust RI policy, which can be found at https://www.unpri.org/download?ac=5205

In cases where a separate RI policy is not created or maintained, this section should contain all the relevant expectations including defining the objectives, establishing guidelines, outlining the portfolio approaches and stewardship priorities and expectations, and setting explicit reporting requirements. Organizations that follow this route must be aware of the resulting difficulties and consistent resourcing that may arise from ongoing IPS and/or IMA negotiations.

Conclusion

The rise of ESG investing presents a tremendous opportunity to E&F investors to align their investment portfolio with their organizational mission. Investors can take advantage of evolving ESG integration practices and investment solutioning to leverage their long-term capital to deliver non-financial impacts to the environment and society, effectively increasing the impact their organization can achieve. It is important to take a measured and thoughtful approach to the translation of the mission statement to investible goals and objectives to ensure that they can be effectively operationalized by investment managers. Consideration should be made throughout the IPS to the investment implications of the fulfillment of stated objectives, and outline expectations for implementation and reporting. An RI policy should be created alongside the IPS to establish explicit guidelines for investment managers on the organization's expectations that maintains reasonable flexibility for fulfillment. CIBC Asset Management has extensive experience working with E&F investors to guide them through the process of creating an effective IPS and RI policy, and is available to work directly with your board or investment committee from consultation through to fulfillment.

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