Heartland Capital Strategies

INTRODUCTION TO RESPONSIBLE INVESTING

TACKLING TERMINOLOGY

KEY TAKEAWAYS

Responsible investing:
- is not a mystery
- is on the rise
- aligns with long-term investment goals
- gives voice to worker rights
- positively correlates with rates of return

About Heartland Capital Strategies

Since 1995, Heartland Capital Strategies (HCS) has been mobilizing workers' capital, i.e., pension funds, towards greater responsible investments in the U.S. and Canada. We do so by convening events, highlighting investment opportunities in the real economy, educating capital stewards, and laying the foundation for bringing together a new generation of responsible investors.

Based in Pittsburgh, Pennsylvania, HCS is a partnership launched by the Steel Valley Authority (SVA), an innovative regional organization that has been successfully restructuring troubled manufacturing firms in the American industrial heartland. HCS's predecessor, the Heartland Labor/Capital Network, was co-founded by the Steelworkers, the AFL-CIO HIT, AFL-CIO IUC and SVA to bring together labor's capital stewards to explore ways to rebuild our economy and reclaim workers' capital. In the aftermath of the 2007-2008 financial markets crash and recession, HCS was re-booted to align its goals with the responsible investment movement and reflect a broader category of services offered.

Heartland's Mini-Handbook Series

In July 2016, HCS staff authored The Responsible Investor Handbook: Mobilizing Workers' Capital for a Sustainable World. The Handbook helps pension trustees re-align their governance and investment strategies with the long-term interests of plan participants (the workers) and their beneficiaries by incorporating responsible investment practices into the investment decision-making process for plan assets.

Heartland’s mini-handbook series takes important topics from the Handbook and breaks them down into individual mini-handbooks, with a focus on addressing barriers to the greater integration of responsible investments in pension fund portfolios. Topics discussed in the series will include: clarifying fiduciary responsibilities; highlighting good corporate and pension fund governance practices; showcasing responsible investments across asset classes; creating effective investment policy statements that take into account responsible investment practices.

Heartland
CAPITAL STRATEGIES

Headquarters
1112 S. Braddock Avenue
Suite 300
Pittsburgh PA 15218
412-342-0534
www.heartlandnetwork.org

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@InvestHeartland

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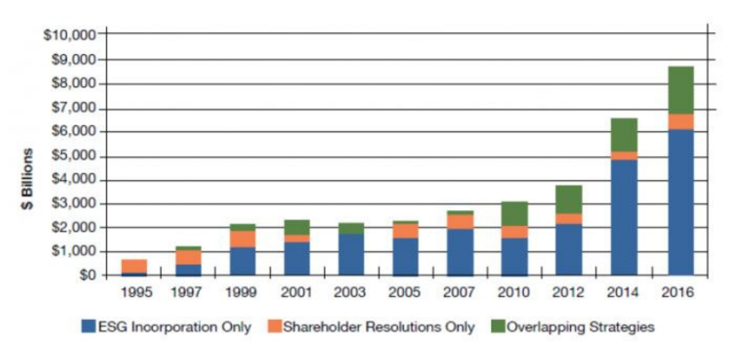
Introduction

As the sun rose on March 9, 2015, a gigantic solar-powered plane called Solar Impulse-2, with a wing span longer than a Boeing 747, took off from Abu Dhabi, UAE, in a historic record-breaking attempt to fly around the world. Per pilots Andre Borschberg and Bertrand Piccard, the aim of the Solar Impulse adventure was not to develop solar-powered planes for widespread use, but rather to showcase the capabilities of renewable energy. According to Piccard, “these technologies now can make the world much better and we have to use them, not only for the environment, but also because they are profitable and create jobs.” Despite snags and delays, Solar Impulse-2 completed the first round-the-world flight by a solar powered plan, returning to Abu Dhabi in July 2016.

The technologies Piccard is referring to are the outcome of responsible investments made by pioneer investors in the early development of clean and renewable technologies. Leading this charge were American pension funds who, for instance, provided the early capital for the decades-old breakthroughs in solar energy that made the flight by Solar Impulse-2 possible. These investors provided part of the capital for early corporate inventors of solar technology such as ATT Bell Labs. They bet on venture capital funds that launched hundreds of solar entrepreneurs. In so doing, workers’ capital - the pension assets and savings of teachers, steelworkers, firefighters, pilots, engineers - everyday working people - has seeded and grown innumerable innovative industries that have had far-reaching, earth-changing impacts.

While investments in clean technologies are more recent, responsible investment itself is not a new concept, dating back to biblical times. According to The Conference on Sustainable, Responsible, Impact Investing (SRI), responsible investing as we know today gained steam in the U.S. in the decades following the 1960s in response to a confluence of concerns regarding “Vietnam War, civil rights, our natural environment and equality for women (which) served to escalate sensitivities to issues of social responsibility and accountability." Labor management issues in the 1970s and a revolt against apartheid in South Africa in the 1980s brought a large number of big institutional investors such as churches, universities, and pension funds into the responsible investment fold. And in recent years, environmental disasters, corporate governance scandals, supply chain issues and climate change, against the backdrop of the great recession of 2007/2008, have increased investor interest in ‘doing well by doing good’ – i.e. investing in ways that make financial sense, while promoting a sustainable planet and a just society.

Concurrently, responsibly managed assets have grown significantly – from $639 billion in 1995 to $8.72 trillion in 2016, representing more than one out of every five dollars under professional management in the U.S. (US SIF)



From U.S. SIF

Still, numerous barriers continue to hold back greater integration of responsible investment practices into mainstream investment strategies. One such barrier is defining what constitutes responsible investments. The other is a fear that responsible investing compromises financial returns.

In this first in a series of mini-handbooks focused on increasing the understanding and allocation of responsible investments, particularly among pension funds, we demystify what it means to invest responsibly and show that responsible investing is compatible with achieving long term competitive financial returns while lowering risk.

So, What Is Responsible Investing?

Just as investors have employed a variety of ways to exercise their desire to do well by doing good, so there is no single term to define responsible investing. As such, responsible investing is often interchangeably referred to as socially responsible investing, social investing, ethical investing, sustainable investing, mission related investing or, more recently, impact investing, among other similar terms.

For example, ethical investing depends on investor preference where some my chose to "eliminate certain industries entirely (such as gambling, alcohol, or firearms, also known as sin stocks) or to over-allocate to industries that meet the individual's ethical guidelines." (Investopedia) And impact investments are "investments made with the intention to generate social and environmental impact alongside a financial return. Impact investments can be made in both emerging and developed markets, and target a range of returns from below market to market rate, depending on investors' strategic goals."

As reflected above, there are some differences in investor approach to responsible investing and consequently the definition used. However, the main idea to keep in mind is “the integration of certain non-financial concerns in the investment process” to help generate competitive financial returns in the long-term alongside positive environmental and social impacts. These concerns are often collectively referred to as Environmental, Social and Governance (ESG) issues.

Responsible investing encompasses a range of approaches and investment options, from passive – such as screening out of investments that run contrary to one’s values or beliefs – to active – such as shareholder engagement and the integration of material ESG issues when arriving at an investment’s intrinsic value. We summarize these approaches on the next page. It should be noted that these are not mutually exclusive; rather, they can be combined to deliver a comprehensive responsible investment strategy.

The Principles for Responsible Investment (PRI), launched in 2006 by the UN Environment Program Finance Initiative (UNEP FI) and various investment leaders for the promotion and expansion of responsible investments, has brought a greater degree of standardization to what constitutes responsible investing. By primarily focusing on the integration of ESG criteria into mainstream investment decision-making and ownership practices, the PRI is inspiring investors globally to think long-term and strategically about ESG risks and opportunities.As of April 2017, the PRI had over 1700 signatories representing $68.4 trillion USD in assets under management.

The evolution toward the PRI’s responsible investment framework also signals a decision to differentiate investors who have a clear mandate to achieve a competitive financial return from investors who are seeking to combine financial returns with social returns usually for religious or ethical reasons. The PRI argues that “responsible investment can and should be pursued even by the investor whose sole purpose is financial return, because….to ignore ESG factors is to ignore risks and opportunities that have a material effect on the returns delivered to clients and beneficiaries.”

2 Common Approaches to Responsible Investing

1 Indexing

A long-term passive investment strategy that seeks to achieve the risk-return attributes of a chosen index

2 Negative Screening

Screening out investments based on one's ethics or values. Investors may either completely avoid investing in such companies or set a materiality threshold for exclusion

3 Positive Screening

Investments in companies that show leadership in ESG matters when compared with their peers

4 Proxy Voting

The right of shareholders to vote on how a company is run, exercised in proxy by delegating instructions to a qualified third party

5 Shareholder Activism

Proactive actions by shareholders to influence the behavior of investee companies – above and beyond the self-issued proxy solicitations by companies

6 Divestment

The sale of an investment with the aim to influence corporate behavior or policy around a financial, governance or ethical issue

7 ESG Integration

Incorporating material ESG issues in traditional investment analysis to determine the intrinsic value of a company and investing in those that are truly operating in a manner that is accountable to all stakeholders

3 Key Characteristics

Similar to the PRI framework, we refer to responsible investing as the pursuit of competitive risk-adjusted rates of return alongside the inclusion of material ESG analysis into investment decision-making and ownership practices. Responsible investments are expected to offer opportunities for long-term value creation that benefit not only investors, but all key stakeholders including employees, customers, suppliers, creditors and the wider community.

Key Characteristics of Responsible Investing

INTEGRATE ESG ISSUES

Integrate ESG issues, alongside traditional financial analysis, into investment decision-making, seeking higher returns while managing risk, rather than simply screening out investments or divesting.

BRIDGE CRITICAL CAPITAL GAPS

Support critical economic development by providing capital to sustainable, productive sectors, from vital infrastructure to energy efficiency to the revitalization of inner cities and rural economies.

FOCUS ON THE LONG-TERM

Recognize the alignment of investment goals, especially long-term retirement benefits, with social and environmental factors impacts.

REMEMBER THE STAKEHOLDERS

Pursue shareholder wealth creation from a long-run perspective that takes into account the impacts of the wealth creation on key stakeholders, particularly employees, the environment and the community.

ACTIVELY OWN YOUR INVESTMENTS

Responsibly execute ownership rights to influence material corporate governance, environmental and social outcomes while enhancing the value of portfolio investments.

4 The Power of Workers' Capital

As mentioned in the introduction, workers' capital has seeded and grown innumerable innovative industries that are having far-reaching, earth-changing impacts. These assets have also seen significant growth in the decades since the mid-1900s when ownership and management of corporate America began to change hands, from founder-owners to large institutional investors and professional managers, respectively. In 2016, pension assets were valued at just over $36.4 trillion USD across 22 major pension markets globally. The U.S. pension assets market - at $22.5 trillion USD and representing 121% of the national Gross Domestic Product (GDP) - is the largest among the global markets. (Willis)

Using their growing retirement assets as leverage, pioneer workers' pension funds were behind early initiatives to invest in the real economy, for e.g. build affordable and workforce housing, revitalize the manufacturing sector and grow the clean economy. In tandem with their union counterparts, these funds have also long emphasized the importance of union representation, worker participation, good wages and workers' health and safety through their investments, promoting the "S" (social) in the ESG framework for responsible investment.

The State of Play

By investing in the capital markets to help finance workers' future retirement benefits, workers' capital has been instrumental in the development of America's economy and its capital markets, fueling growth and prosperity. But as their assets are growing, the influence workers and retirees have on how these assets are used is diminishing.

Declining unions and increasing misalignment of incentives between the owners and managers of corporate wealth have resulted in greater separation between the long-term interests of worker participants and their beneficiaries and the interests of those that oversee, manage and/or use pension assets.

This agency separation has resulted in the investment of pension assets into approaches that ignore long-term risks and that are focused on market timing and short-term gains. It has resulted in short-term profits for shareholders at the expense of sustainable, long-term value creation that benefits all key stakeholders. It has resulted in little accountability for the negative environmental, social and governance (ESG) impacts often generated in the pursuit of short-term gains.

Trustees who oversee pension funds have been challenged by weak governance structures, increased capital market complexities, oversized influence of investment managers and external consultants, and a multitude of regulations. They have sometimes succumbed to institutional herd mentality and suffered "disrupted attention to the fiduciary duties of loyalty and impartiality."

Indeed, the 2008 financial crisis brought on by the sub-prime housing market crash bore testament to the explosive negative impacts of short-term, speculative investments "whose risk profiles pension funds did not fully understand." These misguided understandings impacted not only the financial value of pension assets, but also the livelihood of working people and the broader civil society. Nearly $11 trillion in household wealth vanished, including $4 trillion in retirement accounts and life savings. In addition, millions of jobs were lost and homes were foreclosed, and resources were diverted from important environmental issues such as climate change, among many other negative effects.

Despite lessons from the past, "prevailing theories and practices have not been fully adjusted to reflect systemic and long-term risks that threaten to undermine the security of the pension plan 'promise.'"

This needs to change!

The Power of Workers' Capital

Workers as Shareholders and Stakeholders
Workers' capital can change the status quo and continue to move the responsible investment agenda forward.

The obligation to fiduciary duty requires that trustees not only enable workers to achieve their financial goals for retirement, but also champion a long-term, responsible and activist approach to the management of workers' assets and to promoting workers' interest. By doing so, trustees will be better equipped to preserve and grow retirement capital while maintaining inter-generational equity - the idea that "growth should occur whilst ensuring a certain level of economic, social and environmental security for future generations".[i] In particular, trustees can do much to support greater accountability on social issues within investee companies and capital markets at large.

As shareholders, pension funds can seek to positively influence the behaviour of investee companies through shareholder activism. Such activism can range from private letters or meetings with companies to formal shareholder proposals presented at a company's annual meeting that seek to tackle issues related to governance such as CEO compensation, board of director selection, mergers and acquisitions, as well as non-financial corporate sustainability issues such as human rights, diversity, environmental pollution, etc.

Through shareholder proposals, trustees and other fiduciaries can bring attention to and support those issues that are expected to contribute to the long-term economic best interest of workers and their beneficiaries or that will have no adverse effect on the same. The Department of Labor (DOL) too encourages pension funds to take a proactive approach to corporate issues, rather than merely respond to proxy solicitations, as long as the activism is not an "attempt to further legislative, regulatory or public policy issues," and the benefits exceed the costs involved.

Example of Shareholder Activism
Michael Garland, Assistant Comptroller of the $160 billion New York City (NYC) Pension Funds, points to a long and proud history of shareholder proposal engagement by the Funds in areas such as greenhouse gas emissions and political spending. The NYC pension funds are incrementally working to make companies more transparent and corporate boards more responsive. In one example, the NYC Pension Funds along with CalPERS led the public "VOTE NO" campaign against the Board of Directors of Duke Energy after its coal ash spilled into 70 miles of a river in North Carolina.

As Garland noted, this was the first time that owner investors decided to hold the Board responsible over an environmental issue. In another example, NYC Pension Funds led the "Boardroom Accountability Project" to give shareowners a choice in the election of directors of publicly held companies. To gain greater momentum, the project was initiated by submitting proxy access shareowner proposals to 75 companies simultaneously.

As stakeholders, pension funds as representatives of workers' capital, and, by extension, workers, can exercise their immense influence to include pro-worker policies within their investment policy statement and investment beliefs, enabling funds to positively shape the work practices of investee companies.

As the Committee on Workers' Capital (CWC) repeatedly highlights at its annual meetings, trustees, in keeping with their fiduciary duty, "should promote - and do not weaken – workers' fundamental rights to freedom of association and collective bargaining." By furthering a range of sustainability issues, including accounting for the intangible assets of a company such as its human capital, worker stakeholders can not only advance social and environmental rights, but also secure better performance outcomes for their pension investments.

Workers' Capital at Work

KPS, a part labor funded private equity firm, took a controlling interest in the bankrupt transportation company Motor Coach Industries (MCI) that had factories in St. Cloud and Crookston, MN, and Winnipeg, Manitoba, with 1500 employees. After turnaround, MCI was sold to New Flyer Industries for an estimated $450 million. Previously, in 2002, KPS had restructured New Flyer and sold it at a 750 percent return on investment in 2 years.

The AFL-CIO Housing Investment Trust is providing $24 million of the total $43.3 million development investment necessary to build Portner Flats, a 96-unit affordable housing project currently underway in Washington, D.C.

The Multi-Employer Property Trust helped finance the construction of 9th & Thomas in Seattle. MEPT requires all contractors working on its projects sign collective bargaining agreements with trade unions.

The Employee Real Estate Construct Trust Funds have been in business since 1987 to invest local trade union pensions money in real estate projects. They stand out for their level of involvement throughout the Pittsburgh region.

5 The Drivers

2015 US DOL Pension Guidance

Interpretive Bulletin 2015-01 reconfirmed the legality of ETIs and strongly advised investors to consider ESG thus bringing the US into the modern global responsible investment framework.

Aligning Labor with Global ESG

The AFL-CIO passed Resolution 11 at their 2013 Constitutional Convention endorsing the responsible investment of workers' capital and creating a united front to invest more humanely & sustainably.

Financial Performance Studies

Study after study has shown the positive impact of ESG considerations on both investment portfolios and corporate value.

The 7 Drivers of Responsible Investing

Post 2008 Market Crash Reforms

Short-termism, financialization, financial fraud and outright Ponzi schemes came under greater scrutiny after the 2008 crisis. The Dodd-Frank Act of 2010 aims to increase board involvement and improve shareholder accountability.

Fight for $15 Movement

The Fight for $15 and other national movements such as "Say on Pay" are pressing companies to pay livable wages and reverse income inequality.

Increasing Influence of the PRI

As of April 2017, the PRI has over 1700 signatories with over $68.4 trillion USD in asstes under management.

2015 Paris Climate Accord

The December 2015 commitment from 195 countries (even as the US withdraws from it under the current Trump administration) is a landmark achievement in addressing climate change on a global scale.

6 Why Should Investors Care?

Do responsible investment considerations enhance or detract from the financial value of investments? Is there a strong financial and competitive case for corporations to include sustainable practices in the management of their business? Can a corporation positively serve all stakeholders – customers, employees, shareholders, suppliers, communities, and the environment they inhabit – while simultaneously pursuing its business mission and increasing shareholder value?

The answer is a resounding yes in favor of the positive impact of responsible investment and stakeholder practices on both shareholder and corporate value. This conclusion is based not only on anecdotal references by investors and corporations, but also numerous research studies by academics and industry experts in the field. A small sample of these studies is discussed below.

2009 Wilshire Associates Study

Studies of shareholder activism or "Wall Street Talk" too have shown positive results between responsible investment practices and financial performance. A 2009 study analyzing the impact of CalPERS' corporate governance initiatives (through their focus lists) on the performance of 139 target companies – from the beginnings of CalPERS' engagement in 1987 until fall 2007 – found that "for the five years prior to the "initiative date," the focus list companies produced returns that averaged 84.2% below their respective benchmarks on a cumulative basis, which is equivalent to an excess return of –30.9% per year on an annualized basis. For the first five years after the "initiative date," the average targeted company produced excess returns of 15.4% above their respective benchmark return on a cumulative basis, or about 3% per year on an annualized basis." The 15.4% excess return was roughly the same as since-inception results until 2008.

2011 Harvard Business School Study

This study (Eccles, et al, 2011) compares 90 "high sustainability" firms – those that voluntarily adopted environmental and social policies – with 90 "low sustainability" firms – those that adopted almost no policies – on the issue of governance, culture and performance. The study found that a portfolio of high sustainability firms outperformed a portfolio of low sustainability firms by 4.8% in stock market performance on an annual basis. The results were statistically significant and outperformance occurred in 11 of the 18 years of the sample period (Commonfund, 2014). The latter point is of particular significance since the results suggest that the outperformance occurred only in the longer term.

2012 Deutsche Bank Study

In a 2012 meta-study of more than 100 academic studies from around the world by the Deutsche Bank Group, 100% of the studies in the review found a positive correlation between CSR and financial out-performance, while 89% and 85% of the studies found a positive correlation between ESG factors and market or accounting–based out-performance, respectively.

Why Should Investors Care?

2015 Arabesque Asset Management Ltd. and the University of Oxford Study

A meta-study (September 2015) of over 190 academic studies by Arabesque Asset Management Ltd. and the University of Oxford also highlights results similar to the Deutsch Bank study. The results once again prove that corporate sustainability measures lower the cost of capital (in 90% of the studies) and the incorporation of ESG factors into investment decision-making is positively correlated with market and accounting-based outperformance (in 80% and 88% of the studies, respectively).

2015 Morgan Stanley Report

The report found that investing in sustainability has usually met, and often exceeded, the performance of comparable traditional investments, both on an absolute and a risk-adjusted basis, across asset classes and over time. The review included 10,228 open-end mutual funds and 2,874 Separately Managed Accounts (SMAs) based in the U.S. Specifically, sustainable equity Mutual Funds had equal or higher median returns and equal or lower volatility than traditional funds for 64% of the periods examined over the last 7 years, compared to their traditional counterparts. And sustainable SMAs had equal or higher median returns for 36% of the periods examined and equal or lower median volatility for 72% for the same time frame over their traditional counterparts.

2015 Study of Canadian RI Mutual Funds

This study examines the relationship between risk and return in Canadian Responsible Investment (RI) mutual funds (equity, fixed income and balanced funds), showing that ESG factors, when taken into account, can lower risk in a portfolio. Based on one, three, five, and 10 year observations, the study found that the RI equity mutual funds and the RI fixed income and balanced funds examined outperformed the benchmark 63% and 67% of the time, respectively. Simultaneously, the RI funds were either less volatile than or as volatile as the benchmark, but not more. In particular, the funds were better able to generate excess return at lower risk than the benchmark – 72% of the time for RI equity funds and 61% of the time for RI fixed income and balanced funds – reducing downside risk.

2015 Harvard Law School Report

A comprehensive survey on to-date literature on human capital, the report reviewed 92 empirical studies that examined the relationship between Human Resource (HR) polices and financial outcomes such as return on equity, return on investment and profit margins. A majority (67) of the 92 studies they identified found positive correlations between training and HR policies with investment outcomes. The authors concluded that there is “sufficient evidence of human capital materiality to financial performance to warrant inclusion in standard investment analysis."

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