PATHSTONE IMPACT

SUSTAINABLE INVESTING HIGHLIGHTS

MAY 2019

Climate Risk: A Warning from Pentagon

- The Pentagon recently issued a dire report citing that catastrophic climate change would be a challenge for the United States national security apparatus, largely due to rising sea level and drought. In a Climate Change Impact Assessment sent to Congress, the Pentagon highlighted the vulnerability of "79 mission-essential military installations in the U.S. to flooding and drought, which could lead to wildfires, mudslides, and erosion tied to blizzard." Climate change remains a threat not just to the United States' national security, but also to financial market investments.[1] The impact of climate change and the need to build financial resilience are among investment managers' considerations as they integrate ESG (Environment, Social, and Governance) criteria within their investment strategies.

Earlier this year PG&E became the first corporate utility to file for bankruptcy after having incurred over $30 Billion in potential liabilities resulting from a wildfire believed to be related to PG&E equipment.[2]

Has Investing Responsibly become too expensive?

The growing need for impact investing has increased pressure on managers and companies to pay closer attention to Environmental, Social, and Governance (ESG) criteria as clients and investors demand transparency not just in their investment portfolios, but also on how the companies in which they invest police themselves. A Bloomberg opinion piece by Mark Gilbert noted that increasing demand for transparency requires spending more money on data, and these purchases are coming at a time when investment manager fees are contracting. The need for ESG data has grown significantly, and the cost is increasing right alongside the demand. For instance, Opimas, a capital market consultant, is quoted as predicting that "the cost of buying ESG data will rise to about $750 million next year, an increase of almost 50% from last year, and up by almost 300% since 2014."[3]

According to Gilbert, the surge in demand for ESG data could be linked to the explosion of investment products marketed as socially responsible, the increase in the number of companies who have become signatories to the United Nations Principles for Responsible Investment (PRI), and the recent agreement of many sovereign wealth fund countries, such as Kuwait, New Zealand, Norway, Qatar, Saudi Arabia and United Arab Emirates, to provide transparency regarding their investment portfolios' alignment with "climate-change risk and carbon-reduction strategies."

Gilbert also notes the surge for ESG has fueled a change in the global fixed income market index as well, with proceeds from fixed income issuance known as Green Bonds climbing to approximately $136 billion, all targeted to fund environmentally-friendly investments in 2018. The need for ESG data is providing new opportunities for companies striving to bridge this gap. However, there is a big elephant in the room: Who will pay for the data?

Blindsided! Bill and Melinda Gates Describe 2019's Surprises

A letter written by Bill and Melinda Gates highlights their core dreams for the world and how they are actively working to achieve them through the Bill and Melinda Gates Foundation. The letter began with tales of many surprises, along with how they are using Environment, Social and Governance (ESG) metrics and the Sustainable Development Goals (SDGs) to help address challenges facing the poor in the global south as well as here in the United States.[4] Their first three notable surprises are described below:

#1 Africa is the youngest continent: The continent of Africa has one of the youngest demographic profiles with a median age of 18 years. If the potential for these youth remains untapped, it could trigger instability across the continent. In order to harness the demographic dividend of the continent, Bill and Melinda Gates believe that investing in young people can help double the sub-Saharan Africa share of the global workforce by the year 2050. This will, in turn, unlock a better life for hundreds of millions of people, in alignment with SDGs 3 and 8.[5, 6]

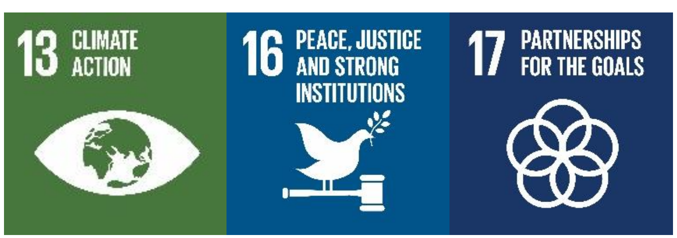
#2 In the future, at-home DNA tests may help prevent premature birth: Bill and Melinda are concerned that fifteen million babies are born prematurely every year, as babies born prematurely are likely to die before their fifth birthday in communities with inadequate medical facilities. However, DNA testing can be used to discover whether an expectant mother has a gene that is linked to how the body uses the mineral selenium, and which may play an important role in determining when labor begins. By understanding this genetic condition, it may lead to solutions that help prevent premature birth.

#3 We will build an entire New York City every month… Bill and Melinda Gates are concerned that global greenhouse emissions are on the rise, and will exacerbate the adverse impact of climate change (SDG 13). The two believe that investment innovations are required to reach a near-zero emission status in areas that are the drivers of climate change—agriculture, buildings, electricity, manufacturing, and transportation. Disruptive investments in these sectors could go a long way in helping solve the challenges of climate change.

The “Benevolent Bully” and the Push for Transparency: the Success of Climate Action 100+

As environmental, social, and governance (ESG) criteria becomes part of investors’ portfolios, small groups of large investors are pooling their resources to drive change. An article by Bloomberg’s Kelly Gilblom describes how a group known as the Climate Action 100+, with approximately $32 trillion dollars in assets, is using their assets to police how corporate organizations conduct their business. The group is encouraging such organizations to embrace climate change adaptation mechanisms set out in the 2016 Paris Agreement. Such actions are needed in order to address concerns highlighted in the UN Sustainable Development Goals.[7]

Realizing it will be nearly impossible for businesses to thrive in a world with unconstrained greenhouse gas emissions, the Climate Action 100+, led by the Church of England and Dutch fund manager Robeco Institutional Asset Management BV, convinced Royal Dutch Shell Plc to adopt near-term climate targets. Shell’s commitment was followed soon thereafter by agreements with BP Plc and Glencore Plc. As noted in the article, the ability to compel corporate companies such as Shell, BP, and Glencore to consider climate change and its potential impact on their respective businesses has made CA100+ the most “benevolent bully” within the corporate world.[8]

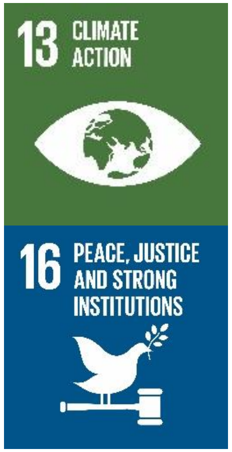


Diversity in the Asset Management Industry

A study conducted by Professor Josh Lerner of Harvard Business School and the Bella Research Group on behalf of the Knight Foundation confirms that gender and racial gaps are still widely prevalent within the asset management industry. In addition, the study found there is no measurable disadvantage, from an investment performance perspective, to having greater diversity. The study found that investment performance is statistically indistinguishable between firms with diverse owners and firms with non-diverse owners. The study highlights four key findings: composition, performance, trends, and data.[9] Data is noted as being essential in order to understand how asset management firms are integrating diversity across the board from low-level employees to top board member composition.

On a related note, Citi recently took a stand by publicly releasing the results of its compensation analysis. The company noted their belief that, to be a high-performing organization they need a team that reflects the places they operate and the clients they serve. In other words, they believe that achieving diversity and inclusion is both good for business and the society as a whole. Citi claims to be the first financial institution to make its "pay equity review" public, with compensation compared between women and men, and between minorities and non-minorities in the United States.[10]

From Liberalism to Wall Street



The hype surrounding ESG (environmental, social, and governance) ratings has attracted the attention of pension funds, institutional investors, and sovereign wealth managers. According to Joel Makower of the GreenBiz Group, investors and managers are now paying close attention to how externalities related to ESG issues affect stock prices and investors' decisions. Such externalities include the physical threats that are amplified by climate change, the need for good governance, the need for greater diversity within the organizational structure, and tragic human rights violations.

Makower notes that, "ESG, it's safe to say, has moved from the margins of liberalism to the middle of Wall Street." He describes how companies will face existential threats more frequently, and as a result will seek to better understand these risks they are facing. In order to better understand, ESG data will need to improve by encouraging good behavior rather than just discouraging bad behavior.[11]

ESG rating as tool for loan pricing

The investment world has begun utilizing environmental, social, and governance (ESG) ratings as criteria for setting the interest rate on a loan. Within the new framework described in a recent article by Heather Clancy in GreenBiz, one financial institution will now pay a lower interest rate on money borrowed if it is able to meet a better ESG rating standard, as measured by the firm Sustainalytics, and will pay a higher rate if it is not able to meet that standard.

As described in Clancy's article, water technology firm Xylem will have an interest rate on a recent loan that can improve or worsen, based on its ESG score. The company currently has an ESG rating on Sustainalytics of 78 out of 100. However, Xylem will pay a lower interest rate if its score rises above 81, and will pay a higher interest rate if its score falls below 75. These guidelines are set out in their filing with the Securities and Exchange Commission (SEC) regarding the loan structure. By using ESG ratings as a tool for loan pricing, the structure should encourage better corporate behavior, and ultimately a better outcome for its stakeholders.[12]

Impact investing fundamentals

An article issued by the Global Impact Investing Network (GIIN), highlights the fundamentals that exemplify what constitutes impact investing in the financial world. GIIN notes that impact investors seek to invest capital to improve people's lives and improve the environment, while increasing positive effects and decreasing negative effects. The article cited the core elements of impact investing as: intentionality, financial returns, range of asset classes, and impact measurement.

- Intentionality is described as seeking to contribute to social and environmental solutions.
- Financial returns is described as risk-adjusted market rate to below market rate, a return range that is higher than a pure grant (a loss of 100%).
- Range of asset classes specifically notes that impact investing can be done across asset classes and is not reserved for private investments.
- Impact measurement requires a commitment of the investor to measure and report social and environmental performance of underlying investments.[13]

Impact Investing within Donor-Advised Funds (DAFs)

The current surge in interest in Environmental, Social and Governance (ESG) and Impact investing has motivated charitable donors to consider incorporating ESG and Impact within Donor Advised Funds (DAFs). In an article in August 2018, Woolworth of the Conservation Finance Network interviewed a number of experts in the area that envision great opportunity to include impact alongside return and risk, when structuring an investment portfolio solution for a DAF.[14]

Since its inception in 1931 by the New York Community Trust, the DAF structure has been used to help donors reach their philanthropic goals through a personal charitable investment account. According to the 2018 National Philanthropic Trust's (NPT) Donor Advised Fund Report, total assets invested in DAFs across the United States surpassed $110 billion in 2017, representing a 27.3% increase since 2016.[15] The growth in DAF assets can be attributed to strong stock market performance, combined with rapidly growing contributions to these accounts.

DAFs could be used to scale up Impact investments. For instance, last year Fidelity Charitable launched investment options for donors who "seek strategies that consider social and environmental factors, while also emphasizing financial returns." Fidelity Charitable has positioned itself as a leading financial institution for DAFs.

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Impact Investing within Donor-Advised Funds (*continued*)

Nick Salter, founder and principal of Progressive Philanthropy, noted in Woolworth's article that sponsors of DAFs (including the charitable arms of Fidelity, Schwab, Vanguard), as well as community foundations and nonprofit organizations, "could provide more direction and encouragement" which could increase donors' awareness and interest in impact investing options. Fidelity Charitable has taken steps to introduce donors to financial advisors such as Pathstone, which strive to integrate ESG and Impact across investment portfolios for mission-oriented investors. *(In a recent publication, Fidelity Charitable lists Pathstone among the few sustainable and impact investing advisor firms. You can read the article on our website www.pathsotne.com/press).*

Woolworth's article describes how the Vermont Land Trust (VLT) and Vermont Community Foundation (VCF) have worked with DAFs to help fund land acquisitions in the State of Vermont. Thus far, by helping donors incorporate social and environmental factors into their DAF investment solutions, VLT and VCF have been able to access a source of low-cost, patient capital that benefits their conservation finance and their work transitioning agricultural land to new farmers.

Foundation's work to promote congestion pricing as a sustainable transit option for NYC pays off

Nurture Nature Foundation (NNF), founded by the family of a Pathstone client, has put its financial resources to good use with its focus on building "sustainable transportation systems." NNF's founder Theodore Kheel was an advocate for mass transit for more than half a century. In 2007, his Foundation took up the cause, funding research and outreach efforts for the following twelve years on how automobile tolls could be used to fund transit. The effort produced results when legislation was adopted this year, to go into effect in 2021, that will make New York the first American city to charge for the privilege of driving within its most congested area, which is defined as the zone below 60th Street in Manhattan. The law is expected to reduce traffic and raise billions of dollars to fund the city's troubled subway system.[16]

Public transportation in urban cities is essential both to the environment and its inhabitants. A study conducted by the Federal Transit Administration noted that, "public transportation can improve air quality, reduce greenhouse gas emissions, save energy, and facilitate compact development, conserving land and decreasing travel demand."[17,18]

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