Investing with Impact and Fiduciary Duty

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Foundations and endowments are seeking ways to increase their participation in this evolving investment arena while protecting their roles as fiduciaries. New guidelines from the IRS make it easier for foundations and endowments to make impact investments that further their mission and target positive financial returns.

Perceived Barriers to Impact Investing

Fiduciaries for public foundations, private foundations and educational endowments are often unsure about their duties in connection to impact investing or mission investing. When faced with the opportunity to consider nonfinancial metrics, such as environmental, social and governance (ESG) factors or mission integration in the investment decision making process, some fiduciaries are concerned that the investment style may violate the "prudent man" or "prudent investor rule.[1]" They may argue that a prudent investor cannot consider noninvestment factors when considering a strategy for inclusion in the organization's investment portfolio. This paper reexamines the role of a fiduciary, identifies recent IRS guidance on mission investing and offers reasons why a "prudent trustee" might consider the organization's charitable mission when selecting a market rate investment. It also offers considerations for a mission investment policy statement (IPS).

Uniform Prudent Management of Institutional Funds Act (UPMIFA)

Institutional funds are governed by federal and state regulations, which embrace the Prudent Investor Rule and comply with the July, 2006 Uniform Prudent Management of Institutional Funds Act (UPMIFA).[2] UPMIFA requires an institution to act "in good faith

[1] Fiduciary Duty in the 21st Century. United National Global Compact. Impact Investing and Private Foundations: New Guidance from the IRS and its Implications for the Field - See more at: http://www.cof.org/event/impact-investing-and-private-foundations-new-guidance-irs-and-its-implications-field#sthash.qpRsvgn0.dpuf

[2] Prudent Management of Institutional Funds Act Summary. http://uniformlaws.org/ActSummary.aspx?title=Prudent%20Management%20of%20Institutional%20Funds%20Act

and with the care an ordinarily prudent person in a like position would exercise under similar circumstances." [3] It emphasizes that investment decisions must be made in relation to the overall resources of the institution and its mission. The "charitable purposes of the institution and the purposes of the institutional fund" must be considered.[3]

The two key issues that must be addressed with respect to impact or mission investing for an organization subject to UPMIFA are the duties of loyalty and prudence. [3]

The Duty of Loyalty

The duty of loyalty requires a fiduciary to be loyal to the beneficiaries of the organization's charitable funds.[3] A loyal fiduciary must act in the best interest of the beneficiaries of the charitable funds and not in their own personal interest. With respect to mission investing, fiduciaries may not select investments that are "'best for the world,''' or best for the trustee, but must consider the charitable purpose of the organization and whether or not it is consistent with the social benefit from the investment. [3]

The Duty of Prudence

The duty of prudence connects more directly to investment decision making. Like any investment, the mission investor must balance cost, risk and return. However, UPMIFA allows trustees to consider "an asset's special relationship or special value, if any, to the charitable purposes of the institution.[3]" Susan Gary, a Professor at the University of Oregon School of Law and Reporter for the Model Protection of Charitable Assets Act and the Uniform Prudent Management of Institutional Funds Act, wrote a paper for the Northwestern Journal of Law and Social Policy entitled *Is it Prudent to Be Responsible? The Legal Rules For Charities That Engage in Socially Responsible Investing and Mission Investing*. With respect to prudence and its application to mission, Gary states that an investment "may either yield an investment return similar to investments made without consideration of mission, or the mission-related benefits may outweigh any reduced financial benefits.[4]" Impact investing is exceptionally prudent when the strategy provides the opportunity for minor or no concessionary market-rate investment returns and yields mission related benefits.

Recent IRS Guidance for Private Foundations

On September 15th, 2015 the U.S. Department of Treasury released guidance on mission investing aimed at private foundations. This guidance clarified that "private foundations can align their investment activities with their charitable purpose or mission when part of a prudent investment policy.[4]" This guidance is specifically aimed at mission or impact investments and is separate from Program Related Investment (PRI) activity. The IRS further clarifies that foundation can make an investment that furthers its charitable purpose in lieu of an investment that may offer a higher target rate of return. By offering this specific guidance, the IRS removed ambiguity surrounding permissible mission investing.

Investing with Impact Policy Considerations

Morgan Stanley defines ***Investing with Impact*** as an investment approach that aims to generate risk-adjusted financial returns while supporting positive environmental and/or social impact. Within the Morgan Stanley Investing with Impact framework, we include ***Values Alignment***, ***Environmental, Social, and Governance (ESG) Integration***, ***Sector Exposure***, and ***Impact Investing*** approaches. This continuum helps our clients identify the type of impact that their investment targets, but use of these strategies should be identified in an investment policy statement.

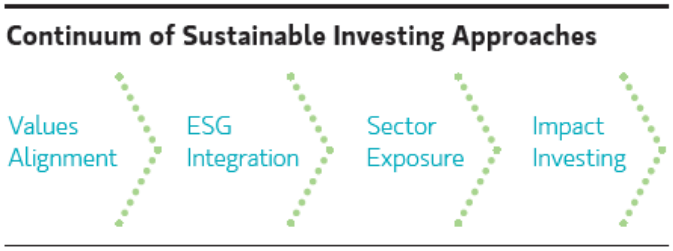
[3] Gary, Susan. "Is It Prudent to Be Responsible? The Legal Rules for Charities That Engage in Socially Responsible Investing and Mission Investing." http://scholarlycommons.law.northwestern.edu/cgi/viewcontent.cgi?article=1062&context=njlsp

[4] Impact Investing and Private Foundations: New Guidance from the IRS and its Implications for the Field - See more at: http://www.cof.org/event/impact-investing-and-private-foundations-new-guidance-irs-and-its-implications-field

Values Alignment: Investments are filtered by interests and values and avoids exposure to potentially objectionable companies and industries. This process does not actively seek environmental and social impact, but is important for organizations that must exclude certain investments that may conflict with their ideology. Religious institutions will often divest their portfolios from industries that offer goods or services against their religious doctrine.

When identifying alignment of values in an impact investing policy statement, fiduciaries would be well served to identify whether they will perform a blanket screen on certain sectors (such as alcohol, tobacco and gambling companies) or choose to invest in "best actors" within a certain sector.

ESG Integration: Commonly refers to investment practices that actively identify Environmental, Social or Governance or sustainability factors when building portfolios. This investment style may have a mission connected goal for a charity that promotes environmental stewardship, diversity and inclusion or gender equality. However, many organizations are using ESG investment strategies purely for financial risk management. ESG investments can potentially identify material, nonfinancial attributes that strengthen a company, such as resource efficiency, workplace diversity and strong corporate governance.



When integrating ESG factors in an impact investing policy statement, fiduciaries should consider identifying which specific ESG factors should be incorporated when building the organization's portfolio. ESG factors could be integrated to help achieve mission goals, financial risk management or a combination of the two.

Sector Exposure: Investments focused on themes and sectors targeting specific environmental or social change. This exposure is niche to a particular industry or sector and may include investments in water or clean energy technology.

Fiduciaries who would like to target specific sectors should identify why these sectors connect to the mission of the foundation. They should develop a process to include these investments in their asset allocation, since sector investments often are thematic and require patient capital.

Impact Investing: This investment style is the most direct effort to affect positive social or environmental change. The investment strategies often provide capital directly to private enterprises or a specific geography. The terms "impact Investments" and "mission investments" are often used interchangeably.

Fiduciaries who would like to integrate impact investments may consider a separate, impact investment policy statement. This statement would identify a process for including impact investments in the investment portfolio. It should identify why it is prudent to connect certain social and environmental issues to the investment decision making process. It could also commit to monitoring social impact of the investment.

Conclusion

New government guidelines and improved metrics for measuring Impact Investments make it easier for fiduciaries to commit more assets to support their missions. Impact Investing can allow foundations and endowments leverage the corpus of their endowment to further their missions. Impact investments are now clearly permissible under the prudent man rule and are a tool that foundations may consider to carry out their mission.

About Us

The Jbara and Rogers Financial Management Group at Morgan Stanley provides investment advice to institutional investors, and family offices. Mark J. Rogers, CIMA® and Gary W. Jbara, CIMA®, Executive Directors, Family Wealth Directors, and Senior Institutional Consultants founded the group in 1985. Six experienced professionals collaborate with the senior partners to provide responsive client service from offices in Farmington Hills, Michigan; Kalamazoo, Michigan; and Chicago, Illinois.

The portfolios we construct consider environmental, religious and social values but seek competitive risk-adjusted financial returns that address global challenges — allowing investors and businesses to leave a positive legacy to future generations. Morgan Stanley's Investing with Impact framework offers investment solutions that consider Values Alignment, Environmental, Social and Governance (ESG) Integration, Sector Exposure and Private Impact Investments. Investments are evaluated with the same research and due diligence as traditional investments. Investors have the opportunity to do well by doing good.

For more information or assistance with creating an Impact Investment Policy Statement please contact John Rogers at John.G.Rogers@morganstanley.com or call us at (800) 819-0949.

Disclosures