Socially Responsible Investing:
Practical Advice for Fiduciaries Considering SRI

This paper provides Board or committee members of Māori trusts and commercial entities, Pacific sovereign funds, foundations, charities and other investors with advice for implementing SRI into their investment organisation

Executive Summary

This paper follows on from our paper entitled *Socially Responsible Investing: What Fiduciary Investment Boards Need to Know*. That paper aims to help boards charged with overseeing investments for the benefit of others in the Pacific sovereign wealth fund, philanthropic, charities and Māori sectors (referred to in this paper as **Investment Stewards**) understand what SRI is and how it fits in with their fiduciary obligations and investment governance practices.

This paper aims to provide practical advice to Investment Stewards who wish to engage in SRI as to how to do so in a way that fulfils their fiduciary obligations and aligns with best investment governance practice. It aims to help Investment Stewards know what to think about and which questions to ask investment service providers when investing responsibly. It also covers what to do if Investment Stewards do not think SRI is appropriate for their organisation just yet.

Considerations for Investment Stewards in Incorporating an SRI Strategy

As a result of many factors, including consumer demand and the global push towards sustainable development, SRI is becoming better understood, better executed and more and more popular in markets around the world, including in New Zealand and Australia. There can be many benefits for an organisation in engaging in SRI. It enables organisations to ensure their investments align with their purpose and values and have a positive impact on society through responsible allocation of their capital. When it is done well and with proper due diligence, Investment Stewards can increasingly expect to receive returns equal to or greater than comparable non-SRI funds.

However, Investment Stewards must view SRI through the lens of their fiduciary obligations and proper investment governance processes. We have set out below some of the important questions Investment Stewards should ask themselves when thinking about investing responsibly.

Investment Stewards must develop sufficient expertise in SRI in order to properly understand, structure and regularly monitor an SRI strategy.

1. Is an SRI strategy appropriate for this organisation?

The first question Investment Stewards must ask themselves is whether an SRI strategy is appropriate. Steps to take to answer this question include:

- checking the governing documents of the organisation to see whether SRI is consistent with them and whether they include any guidance or requirements relating to SRI. Depending on the entity, relevant governing documents could include a trust deed, constitution, legislation and others;
- checking whether any donors to the organisation have imposed restrictions on how their donation can be invested that might demand or restrict an SRI approach;
- considering the purpose and mission of the organisation and whether this implies certain SRI principles should be adopted. For example, it is reasonable to deduce that a cancer charity would want to screen out investments relating to tobacco or that a Māori trust with guardianship of a particular river might want to avoid investing in companies that harm that river through their activities; and
- evaluating whether adopting an SRI strategy will disproportionately increase risk to the organisation or decrease returns. If so, proceeding with it will likely breach fiduciary obligations. If not, Investment Stewards should have evidence to show this is the case by comparing the risk and return profile of the proposed SRI funds or securities with a broader peer group and indices representing the asset class.

2. Develop a philosophy for SRI: what is the best SRI strategy for our organisation?

Investment Stewards are usually responsible for managing the investment process and designing an investment philosophy and strategy to be owned by the board, not choosing individual investments. Therefore, some of the factors that Investment Stewards should consider when devising an SRI strategy include:

- the reasons for which an SRI strategy is deemed appropriate for the organisation (for example, the organisation's purpose and values) and the SRI goals derived from these;
- which SRI approaches would work best to achieve the organisation's SRI goals;
- which SRI approaches are likely to have a positive or neutral impact on returns for the organisation and which will be most practical to implement and regularly monitor;
- what impact the proposed SRI strategy will have on portfolio diversity, a key to fulfilment of fiduciary obligations and to investment performance; and
- how the organisation might evolve over time and how this might affect the long-term direction or phases of development of the SRI strategy.

Considering these factors will help Investment Stewards construct the foundations of the SRI strategy on which the detail can be built. For example, it might become clear that the environment is particularly important to the organisation and is a key foundation for the organisation's SRI strategy; this might point to certain sustainability-focussed SRI products being the best choice for the organisation.

3. How do we properly document our SRI strategy?

In keeping with best investment governance practice, any SRI strategy should be clearly set out in the investing organisation's Investment Policy Statement (**IPS**).

An IPS is a board-owned investment management plan that sets out the organisation's investment objectives, philosophies and specific policies. It establishes the roles and responsibilities of all parties involved in the investment process and diversification and rebalancing guidelines. It also sets out due diligence criteria to be used in selecting investments and investment service providers, monitoring criteria for investments and investment service providers and procedures for controlling and accounting for investment expenses.

All of these components of the IPS must be tailored to address the SRI strategy, especially the due diligence and monitoring processes. The IPS should also explain why the Investment Stewards consider it is appropriate to adopt an SRI strategy and the social, environmental and financial impact it is intended to achieve.

4. Due diligence: what questions should we as Investment Stewards ask our investment service providers?

Conducting due diligence before investing is a key part of Investment Stewards' fiduciary obligations. This is especially true with SRI and Investment Stewards must develop sufficient expertise in SRI in order to properly understand, structure and regularly monitor an SRI strategy.

Investment Stewards must conduct due diligence on investment service providers, both during selection of a service provider and in beginning to implement an SRI strategy with an incumbent service provider. Relevant service providers can include investment advisers, fund managers and, when dealing directly in investments, stock brokers. When implementing an SRI strategy, due diligence should include ensuring the service provider has SRI experience and employs SRI approaches to a degree and for reasons that are appropriate for the investing organisation. Investment Stewards must also ensure service providers understand the organisation's values, mission, reasons for implementing an SRI strategy and financial goals and be satisfied that their processes are aligned with these factors.

The process of selecting investment service providers is arguably a fiduciary act. This means the process followed must focus on relevant issues only (not, for example, brand and personal connections) and be robust enough for Investment Stewards to be able to point to legitimate reasons why a service provider was selected. Addressing irrelevant issues in the selection process may be deemed to demonstrate lack of investment governance knowledge or incompetence on the Investment Stewards' part and may bring into question the credibility of the assessment process.

Specific questions Investment Stewards (or their advisers) can ask their current or potential investment managers when starting to implement an SRI strategy include:

- What is your previous experience with SRI?
- Do you have any independent verification of your SRI integrity and practices (for example, from the Responsible Investment Association Australasia (**RIAA**))?
- Is your organisation a signatory to the UN Principles for Responsible Investment?
- What is your approach to SRI and do you have a policy setting this out?
- What SRI products do you offer? What is their financial size and how many investors are invested in them?
- What is the cost of your SRI product and is it different to the cost of similar non-SRI products?
- Are there any components in your SRI portfolio or securities being recommended to us that are not subject to SRI criteria?
- How do you use your influence as a shareholder to engage with companies on issues that are important to my organisation?
- Can you give examples of securities you hold based on SRI factors and explain why they were purchased?
- In the course of your routine performance reporting, how do you make sure you assess the performance of your SRI products against both SRI and non-SRI appropriate benchmark indexes?
- How do your SRI products perform compared to both SRI and non-SRI appropriate benchmark indexes?

5. Monitoring: what ongoing actions relating to our SRI strategy must we take as part of our investment governance processes and fulfilment of our fiduciary obligations?

Investment Stewards must regularly monitor whether SRI investments and service providers are achieving the intended results. This means Investment Stewards must receive regular reports relating to the investments and service providers covering quantitative factors (for example, performance) and qualitative factors (for example, executive skill, reporting quality and investment philosophy) and Investment Stewards must assess these for consistency with the SRI strategy. As a guide, the following are some of the key areas to address in a board's monitoring procedures:

- **Review of service agreements:** As is best investment governance practice, agreements with investment service providers should be reviewed at least three yearly for pricing competitiveness, terms that are consistent with the Investment Stewards' fiduciary obligations, nature of services and reporting standards, and changes within the service provider organisation.
- **Review of SRI policy:** Investment Stewards must also annually review the overall SRI strategy they have in place, amending it if necessary, to make sure it is still aligned with the purpose, values and financial goals of the organisation.
- **Performance comparisons:** When considering performance by comparison, use both SRI and non-SRI indices and peer group funds representing the relevant asset class in order to ensure that returns are not being compared to an underperforming sub-set of securities or funds.
- **Cost comparisons:** When assessing whether the cost of the SRI product is reasonable, compare it with the cost of both similar SRI products and non-SRI products.

6. Knowledge development: what must we do to keep learning about SRI and keep up with SRI developments in the sector?

As mentioned above, Investment Stewards must have the time, inclination and skill to oversee the investments they have authorised. This requires them to develop sufficient knowledge of SRI and the different approaches to SRI, such as ESG Integration, Screening and others, to properly develop, implement and monitor an SRI strategy for their organisation. The ongoing monitoring of SRI products and service providers can become time-consuming and challenging as products and organisations evolve. We have witnessed how portfolio investments have become more varied and complex in nature and SRI products are heading the same way.

Actions Investment Stewards can take include:

- having a board sub-committee, such as an investment committee, focussed on monitoring investments and keeping themselves and the rest of the board up to date with the evolution of SRI;
- finding relevant and helpful resources following the development of SRI in New Zealand and Australia, for example, the RIAA's annual benchmark reports focussing on those respective markets;
- taking extra time outside regular monitoring activities to ensure a better understanding of SRI throughout the process of integrating SRI into the portfolio and possibly making such integration a staged process; and
- considering how the organisation will respond to breaches of its SRI policy if they occur since the board's reputation can be at risk when policy and implementation or practice do not match. This can occur both through poor implementation or providers failing to adhere to stated aims following implementation. The key is for Investment Stewards to have thought through potential responses to such events prior to them occurring and beneficiaries raising concerns on finding information that points to a breach of policy.

Not For Us Right Now, Thanks

For some organisations, now might not be the right time to adopt an SRI strategy. This might be because the Investment Stewards and management need more time to develop the knowledge and capacity to implement and monitor an SRI strategy or because there are not yet any SRI products in the market that are appropriate or sufficiently cost-effective for the particular organisation's needs.

If Investment Stewards decide not to engage with SRI, it is important to record clearly in board documents the specific, substantive reasons for which SRI is not considered appropriate at the time and when the question will be revisited. This is so it is evident that the Investment Stewards gave due consideration to the issue and followed an appropriate and informed decision-making process. This helps to minimise any reputational risk for the organisation or Investment Stewards arising if the decision is judged with hindsight by future trustees, beneficiaries or other stakeholders of the organisation.

Conclusion

Investment Stewards of organisations wishing to incorporate an SRI strategy into their investment processes must do so in a way that fulfils their fiduciary obligations and complies with best investment governance practice. This includes devising an SRI philosophy and strategy that aligns with the organisation's values, purpose and environmental, social and financial goals. It also includes conducting thorough due diligence on SRI products and investment service providers before implementing the strategy and monitoring performance on an ongoing basis. Done well, organisations can enjoy the many benefits of SRI while Investment Stewards fulfil their obligations.

Issued by fi360 Pacific, February 2017
Contributors: Ross Fowler AIFA® and Melanie Potter LLB BA

For more information, visit our websites at www.fi360.co.nz and www.myfi.support