Building a responsible investment portfolio

A six-step guide for not-for-profit Boards and Investment Committees

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The journey towards responsible investing is more than a trend. It's a fundamental shift in how investors evaluate the impact of corporate governance, the environment, and social factors on their investments. Building a portfolio that reflects an investor's commitment to ethical principles and long-term sustainability whilst generating stable returns can be challenging.

For many not-for-profit investors, the alignment of investments with organisational missions and values is not just preferable, it is a responsibility. This six-step guide equips not-for-profit Boards and their Investment Committees with a framework to navigate this complex landscape. From understanding the spectrum of responsible investment strategies to leveraging the latest analytical tools and frameworks, this guide explores the elements that constitute a robust responsible investment portfolio.

1 Understand your governance obligations

The Board has a fiduciary duty to ensure that any assets held are protected and used appropriately in line with the organisation's mission. This involves developing a prudent investment strategy, adopting an investment policy, and potentially delegating day-to-day investment responsibilities to a committee or professional manager whilst retaining oversight. The Investment Policy should address risk and return objectives, access to liquidity, and any commitments to socially responsible investing.

2 Define your values

Before you can begin establishing how responsible investing is considered within your portfolio, you need to define your values in the context of investing. What do you care most about? What are your priorities when it comes to your broader investment objectives?

Here are five topics we recommend discussing with your Investment Committee and Board to define your values:

1) Which responsible investment values are most important to you, your key stakeholders and your organisation? Perhaps it's climate change, human rights, equality or preventing animal cruelty?
2) What role do you want screening to play within your portfolio? Is it to eliminate certain industries or sectors? Or perhaps it's to include certain business activities that align with your mission?
3) Is there a materiality threshold for certain activities you would prefer to exclude? For example, could you tolerate investing in a company if they only generated 5% of their revenue from excluded activities?
4) How do you expect your managers to engage with and vote the shares of the companies they invest in on your behalf? Do you want them to be actively engaging on environmental, social and governance factors? Do you want them to also be utilising proxy voting to have a positive impact?
5) How important is it for your investment portfolio to follow the broader market over shorter time horizons? Responsible investment funds can have a very different universe to the broader market which can create tracking error, particularly over shorter time horizons.

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Document your investment strategy

Effective governance and management of investment risks are vital to achieving long-term financial and mission-related outcomes. Your Investment Policy serves as a foundational document that guides your investment strategy. It outlines allowable asset classes, target asset allocation, and sets benchmarks for performance measurement and reporting. This document ensures continuity in investment strategy through changes in Board or Investment Committee members and should be periodically reviewed to align with your organisation's evolving objectives. It is therefore critical that any decisions you make regarding responsible investing are clearly documented. Within your policy it is important to focus on your broader values and implementation considerations; however, the details of how you will invest do not need to be recorded here. These are your guiding principles.

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Assess how your portfolio aligns to your Investment Policy

Before you start thinking about any changes it is important to really understand how your current portfolio aligns to your Investment Policy.

- What exposures do you have to business activities, sectors or countries that you don't want? Do you have a materiality threshold for defining these?
- If climate is an important value for your organisation, what is your current portfolio's carbon footprint and is it on track to achieve the Paris Agreement's goal to limit temperature increases to 'well below 2°C' by 2050?
- Are there any social goals or metrics you are looking to track?
- How are your current managers engaging with their holdings and voting their shares?

Investing funds with professional fund managers who select different assets based on different investment mandates is the most common approach. By utilising a range of investment managers, you can not only access very specialist expertise; you can also help diversify your portfolio across asset classes, sub-asset classes and manager styles. However, by delegating this responsibility you relinquish control of the stocks or bonds selection. This means that if you hold exposures that you do not want to invest in, it is not as simple as removing that exposure. You will need to remove any manager that holds that exposure and employ a new manager that abides by your investment philosophy which can result in a significant transition.

Instead, you may consider making some trade-offs. For example, can you tolerate some exposure to certain sectors if you are gaining exposure to other sectors? Or, are you comfortable with maintaining certain exposures if the manager has a comprehensive and values driven approach to engagement and proxy voting?

These compromises may require you to revisit your Investment Policy. Otherwise, the next step is to establish a transition plan to exit these managers and employ new ones. The tax-exempt status of most not-for-profits enables more flexibility in portfolio changes without tax implications, however there will still be transaction costs associated with any changes.

An investment adviser, such as Perpetual, can work through your options regarding acceptance versus exclusion and any likely cost implications of changing your manager line up.

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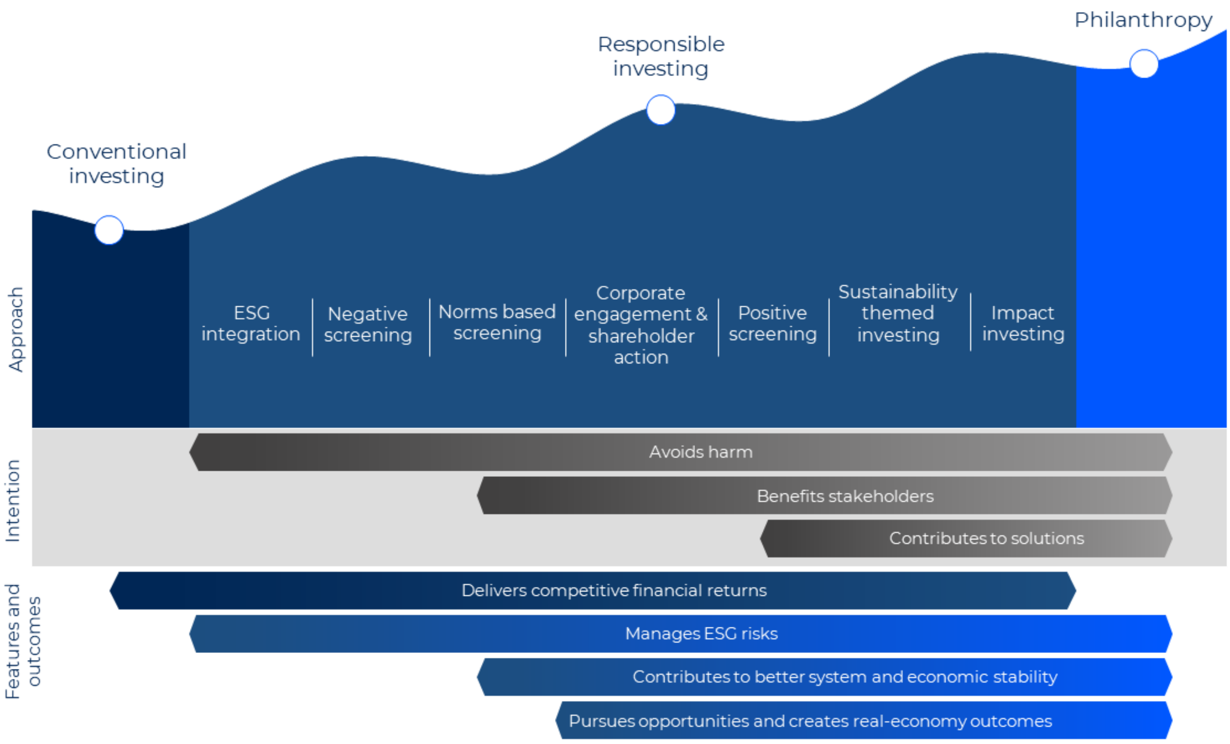
Optimise portfolio construction and risk management

If you do need to consider new funds, the next step is to identify which managers are going to align best with your organisation's goals and complement the strategies you intend to maintain. The objective here is to find a blend of managers that will not only meet your responsible investment goals, but also optimise your risk and return outcomes. There are a range of different responsible investment approaches managers can take – from screening, through to integration and impact investing – which are outlined in diagram 1 below. Typically, investors will adopt a range of styles to help manage investment risk and improve diversification.

While integrating Environmental, Social and Governance (ESG) considerations into your portfolio can mitigate certain risks, there is a cautionary note on taking an overly concentrated approach (only using one type of responsible investment strategy). This can introduce tracking error resulting in significant variance from standard benchmarks, particularly over shorter timeframes. This is a trade-off your Board and Investment Committee may be comfortable making; however, it is possible to reduce this risk by diversifying across responsible investment strategies if desired.

Diagram 1 – The Spectrum of Responsible Investment Strategies



Source: RIAA

6 Implement and monitor

Once you have approved your new manager line up and the amount you intend to allocate to each, the final stage is to establish a transition plan to help manage out-of-market risk (the amount of time you are not invested in the market) and transition costs.

Once implementation is complete, it's important you continue to monitor the application of your responsible investment objectives as you would all other aspects of your Investment Policy. Where you have materiality thresholds in place, you want to ensure these are not breached. You may also want to track the carbon footprint of your portfolio as well as your managers' engagement activity and proxy voting records. Reporting from your managers and advisers will be critical here. This type of reporting does exist but you may need to ask for this to be provided.

As you embark on, or continue, your responsible investing journey, remember that this six-step guide is just the beginning. Whilst these steps offer a solid foundation for aligning your investments with your organisation's values and goals, the landscape of responsible investing continues to evolve. Navigating it can be complex, but you're not alone. Our team is committed to supporting you every step of the way. Whether you're seeking to refine your investment strategy, address new challenges, or simply have questions, we're here to provide the expertise and guidance you need.

Start the conversation

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