BANK OF AMERICA

CHIEF INVESTMENT OFFICE

Impactonomics®

Making an Impact through Sustainable Investing: Institutions, Investment Returns and a Better World

August 2022

More and more, institutions are examining how sustainable and impact investing — or investing with the intention to seek positive social and environmental effects while targeting competitive financial returns — may help them better align their investments with their missions and potentially reduce their risk. What's more, in a shift from the recent past when equities were the asset class where most sustainable investments were available, institutions are now discovering more options across a range of asset classes, including equities across geographies and fixed income, alternative investments and even non-traditional asset classes, enabling them to activate total sustainable portfolios.

Sustainable and impact investing is no longer the niche strategy it once was. One clear sign of this move into the investment mainstream is the abundance of related news headlines. A search online turns up reports of asset managers launching sustainable funds, foundations increasing their impact allocations, academics releasing more studies and investors pledging to integrate environmental, social and governance (ESG) into investment decisions.

Sustainable investing's broader acceptance is also reflected in the assets portfolio managers have committed in the short and long term, on behalf of individual/ retail investors as well as institutional investors. U.S. sustainable funds attracted a record $69.2 billion in net flows in 2021, a 35% increase year over year. Assets under management (AUM) in U.S. sustainable funds settled at a record $357 billion as of end of 2021, more than four times the AUM at the end of 2018.[1] As of September 2021, $3 out of $10 of global equity inflows are going into ESG with AUM remaining at $1.6 trillion across 2,300+ global ESG funds, according to BofA Global Research.[2]

KEY IMPLICATIONS

In this report we examine a number of factors, including:

- Sustainable and impact investing in the mainstream.
- Factors motivating institutions to begin investing to create a positive impact.
- Steps to implement sustainable investment strategies.
- Opportunities and challenges often associated with aligning mission and investments.

INSTITUTIONS: A GROWING ESG COMMITMENT

More than half (59%) of U.S. institutional investors, from philanthropic foundations to public funds, are incorporating ESG principles or decision criteria into their investment decision-making processes to create alignment between their organizational values and their investment objectives.[3] Furthermore, nearly two-thirds of institutions include ESG factors in their Investment Policy Statement (65%) and another 19% plan to make necessary updates to reflect these factors.[4]

[1] Morningstar, "Sustainable Funds U.S. Landscape Report," January 2022.
[2] BofA Global Research, *"ESG Quant Edge: ESG investing by the numbers,"* October 2021.
[3] Cerulli, "*U.S. Environmental, Social, and Governance Investing 2021 – Aligning Investment Portfolios with ESG Considerations*," 2021.
[4] Ibid.

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MORE DATA, DISCLOSURE AND STANDARDS LEAD TO ESG ADOPTION

A number of factors are behind this growing acceptance. A decade or so ago, few companies identified ESG factors that might materially affect performance, and industry standards for measuring ESG performance were virtually nonexistent. Lacking the kind of data they would normally seek to make investment decisions, investors were understandably cautious. Today, the ESG landscape is vastly different. From only 20% of the companies in the S&P 500 issuing formal sustainability reports in 2009, 10 years later the number had exceeded 90% of firms.[5] And institutional investors are taking advantage of this additional disclosure. In the 2021 NACUBO-TIAA Study of Endowments, over 80% of respondents noted that they include ESG in their investment policy statements.[6]

We also see research companies such as Thomson Reuters and Sustainalytics have extensive databases of structured and standardized ESG data. And MSCI has created over 1,500 equity and fixed income indexes that include ESG data, used by financial institutions around the globe, helping investors more effectively benchmark, measure and report on their ESG investment performance.

Standard setting organizations, such as the recently established International Standard Setting Board (ISSB), have been set up in response to calls from financial regulators to align the sometimes competing sets of standards from the Sustainable Accounting Standards Board (SASB) and other standard-setters in the ESG space — and will work to increase alignment on what data is material to each industry. Other research increasingly points to the potential for such information to be a positive addition to traditional fundamental analysis.

As the value of intangible assets — which can include a company's intellectual property such as patents, how it manages its brand and attracts and retains its employees and the environmental impact and sustainability of its supply chain — continues to grow as a major component of the S&P 500's market capitalization, it has become increasingly important to gain insights into those assets and to understand how management teams are addressing these issues, from the perspective of both investors and asset managers.

This trend has been recognized by the Department of Labor (DOL) as it announced a decision to not enforce rules that limited inclusion of ESG-factors in the investment decisions and proxy votes of retirement plans. In fact, the DOL has recently announced that it intends to begin consultations "to determine how to craft rules that better recognize the important role that environmental, social and governance integration can play in the evaluation and management of plan investments, while continuing to uphold fundamental fiduciary obligations" as they relate to ERISA investment management and the fiduciary responsibility of plan sponsors.[7]

This seemingly subtle shift — official recognition of the importance of ESG factors — has resonated for many in the institutional world. Companies with better environmental, social and governance ratings have been seen to be more profitable and paid higher dividends.[8] As we see the U.S. economy becoming more closely tied to ESG factors, and as we see the world undergoing a host of long-term transformations, we believe that institutions overall are more likely to embark on a sustainable or impact investing journey once they recognize that achieving their mission may depend, entirely or in part, on consideration of the full impact not only of their grants and programs but also of their investment portfolios.

[5] Governance & Accountability Institute, Inc., *2020 S&P 500 Flash Report*, July 2020.

[6] "2021 NACUBO-TIAA Study of Endowments," National Association of College and University Business Officers and Teachers Insurance and Annuity Association of America, 2021.

[7] ThinkAdvisor, "DOL Won't Enforce New Rules on ESG in Retirement Plans," March 18, 2021.

[8] World Economic Forum, "What is sustainable finance and how is it changing the world," January 2022.

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The Chief Investment Office (CIO) has developed Impactonomics, a sustainablity-related analytic lens that includes these factors while also examining a range of relationships between economic growth and investing for impact and profit, as well as the measurable social and environmental change sustainable investing can enable.

INSTITUTIONAL INVESTMENTS AT BANK OF AMERICA

The CIO's investment process reflects the interests, concerns and circumstances of each foundation or endowment. We believe that diversified multi-asset class portfolios using a mix of investment vehicles can benefit from multiple sources of return and may help each of our clients meet their mission. A holistic suite of investment management and planning capabilities is delivered through the Outsourced Chief Investment Office (OCIO) offerings, whose tenets help to manage portfolios and provide planning guidance for institutional clients. We have seen an uptick in the number of clients looking not only to deliver sufficient investment returns for their particular spending policy requirement, but also to align their investment policy itself with their overall mission.

The universe of sustainable investments

Sustainable and impact investments are those that seek positive social and environmental effects while targeting competitive financial returns. A spectrum of approaches to sustainable investing exists, and increasingly the approaches are blending. Focus has been shifting from the more traditional socially responsible approaches (typically screening out or avoiding objectionable companies) to sustainable or "best in class" approaches, which compare companies to their peers on various factors and select top performers. CIO's Socially Innovative Investing (S2I) suite of strategies highlights this type of strategy that doesn't necessarily exclude exposures but seeks to invest in companies that benefit a broad group of stakeholders.

Other sustainably focused strategies target ESG engagement with portfolio companies through shareholder advocacy and proxy voting, a form of active ownership and an alternative to screening out companies. Thematic approaches, incorporating views on market opportunities in strategies seeking sustainable growth, provide the benefit of exposure to growth areas with a tangible narrative of supporting change. In addition, "contribute" approaches begin with social or environmental concerns and seek market based strategies.

Avoid

Seek to reduce negative social or environmental effects and manage risk by limiting certain exposures

Benefit

Seek to support positive social or environmental practices and enhance potential for long-term competitive financial returns

Contribute

Seek to advance positive, measurable social or environmental outcomes and target opportunities where impact is intrinsic to financial performance

The "A-B-C" framework that helps classify the impact objective of a sustainable strategy was adapted from The Impact Management Project. The Impact Management Project is a forum for building global consensus on how to measure, compare and report ESG risks and positive impacts.

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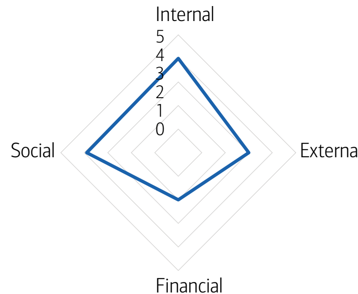
MOTIVATORS

To understand what's driving these institutions to turn to sustainable and impact investing and encouraging them to incorporate ESG into their investment policy and practice, the Chief Investment Office points to several illustrative scenarios of motivators and dynamics that form a network effect of discussions and action by institutions around sustainable and impact investing (motivators are ranked on a scale from 0 to 5, with 5 being the strongest motivation):

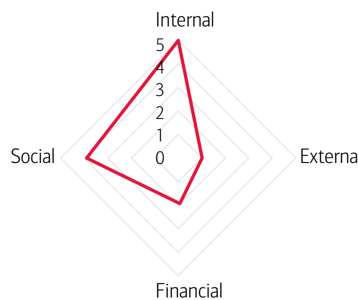
University Endowment

Current students (*internal*) and alumni base (*external*) drive motivation towards sustainable investing often driven by fossil fuel divestment discussions (*social*). Long term horizon for funding operations in perpetuity (*financial*).



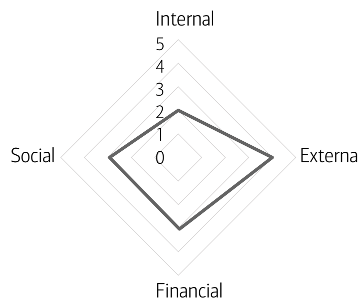
Religious Organization

Members of the religious community (*internal*) and governing body seek alignment with their religious views (*social*). Financial returns are certainly important for religious organizations, while external considerations outside of the membership of the organization are likely lower than some other institutions.



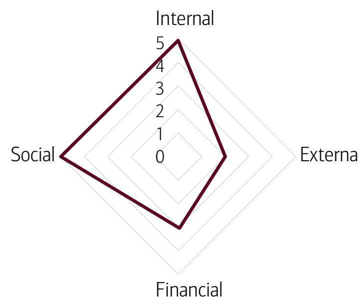
Community Foundation

Donors (*external*) often drive interest, seeking additional social impact (via an organization created to serve a community) and consistent financial returns are required to meet spending policy (*financial*).



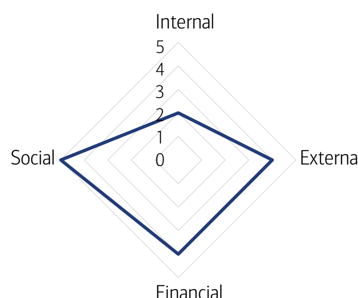
Private Family Foundation

Primary driver is the family desires (*internal*), and they see both the opportunity for increased impact and alignment (*social*) as well as opportunities for financial benefit (*financial*). Lower worries about public relations or any external forces.



Social Services Organization

Board members (*internal*) and donors (*external*) seek sustainable investment returns (*financial*) for an endowment whose mission is to improve the lives of women, youth and children experiencing homelessness (*social*).



INTRODUCTORY QUESTIONS

For Institutions

SOCIAL

- Would you have reputational risk if your portfolio was on the front page of the local newspaper?
- Does your institution's investment portfolio run counter to your mission in any way?
- What risks might your portfolio have that ESG factors might highlight?
- If the opportunity for "perfect" mission alignment is lacking, do you see value in investing in a portfolio of companies with superior social characteristics that might be consistent with the overall spirit or philosophy of your organization?

FINANCIAL

- Are there market-driven approaches to your mission that would make compelling investments?
- How do you reflect on the research around the materiality of ESG?
- How do you see ESG factors being priced into the market?

INTERNAL

- Where in the organization is the most energy for (or the most skepticism about) sustainable investing?
- Would it require resources to unleash them?
- What partnership doors might it open?
- What controversies might it present?

EXTERNAL

- How does your preferred supporter base view sustainable investing?
- How many of your constituents are enquiring about sustainability today, compared to previous years?
- How do you compare to peer organizations in your approach to sustainable and impact investing?
- Is your organization viewed as a thought leader? Fast follower? Risk averse?

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Social: Aligning values and supporting mission

In the past, socially or environmentally based motivations often resulted in investing with a “do no harm” approach, which could be rather sweeping in its implementation. For instance, a religious organization might choose to avoid all “sin stocks,” or an environmental non-profit might exclude companies with significant chemicals-related controversies. Today, this kind of values alignment is usually more nuanced, typically involving a periodic review not just of a company’s products and services but also its environmental and social practices compared to its peers.

In addition to aligning with their values, institutions may also search for investments that advance their mission. This is especially true in areas where there are market-based approaches to social change such as disease prevention, job creation in geographically targeted areas or resource conservation. In this way they move from a values lens to a sustainability or mission-aligned lens, so to speak — but the underlying social drivers remain the same.

Financial: Risk mitigation and long-termism

Some institutions turn to ESG integration because of their investment beliefs. As the economic landscape shifts, sometimes rapidly, they believe ESG factors can provide deeper insight into both long-term risks and long-term opportunities. These institutions may seek managers who can detail their use of ESG factors within a value-added, consistent methodology. They may consider strategies that tilt portfolios away from potential risk factors or that provide diversification to reduce portfolio concentrations. They may also see particular areas of opportunity, such as emerging and minority-owned asset managers.

External: Current and future stakeholders

Institutions may initially consider sustainable investments when there is pressure from outside the organization. Constituents, especially younger and wealthier donors and clients, may be seeking organizations that leverage all of their assets for their mission. Students at some universities, for example, have been organizing to persuade endowments to divest from fossil fuels and invest in a low-carbon transition.

In an era of constrained philanthropic capital, donors may inquire about an institution’s investing practices. Some foundations find that holding events related to sustainable investing themes connected to their mission (such as gender equality, land conservation or homelessness) helps them connect to a new set of partners and collaborators, and builds stronger connections to their donors. For these groups, sustainable investing becomes a differentiator signaling their commitment both to mission and to innovation.

Internal: Deep expertise and opportunities for leadership

An organization’s own staff may express significant interest in exploring sustainable investing. An Executive Director may have a vision for complementing current grants by sustainable investments. Or she may harbor concerns about reputational risk from not fully reviewing whether investments and mission align. Others may see opportunity stemming from a particular expertise — for example, a water engineer may have insights into the accurate assessment of water risk in a portfolio; or a poverty alleviation organization may see the demand for low income housing through a unique lens. The opportunity to expand impact and create durable change may resonate with those who have years of experience in grant-making and an intrinsic understanding of the systemic nature of change. In addition, employees may find a sustainable and impact investing program appealing from the perspective of leadership in advancing a mission’s agenda.

Top ESG Considerations for Institutional Investors

Conflict Risk
(Terrorist or Repressive Regime)

Climate Change/Carbon

Tobacco

Board Issues

Sustainable Natural Resources/Agriculture

Source: “2020 Report on U.S. Sustainable, Responsible and Impact Investing Trends.” US SIF, 2020.

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Institutional investors: Implementation

Once an institution clarifies its motivations, it can shift to the implementation process. Leveraging the Avoid, Benefit and Contribute investment approaches mentioned earlier, institutions can construct portfolios that align with their financial and sustainability goals.

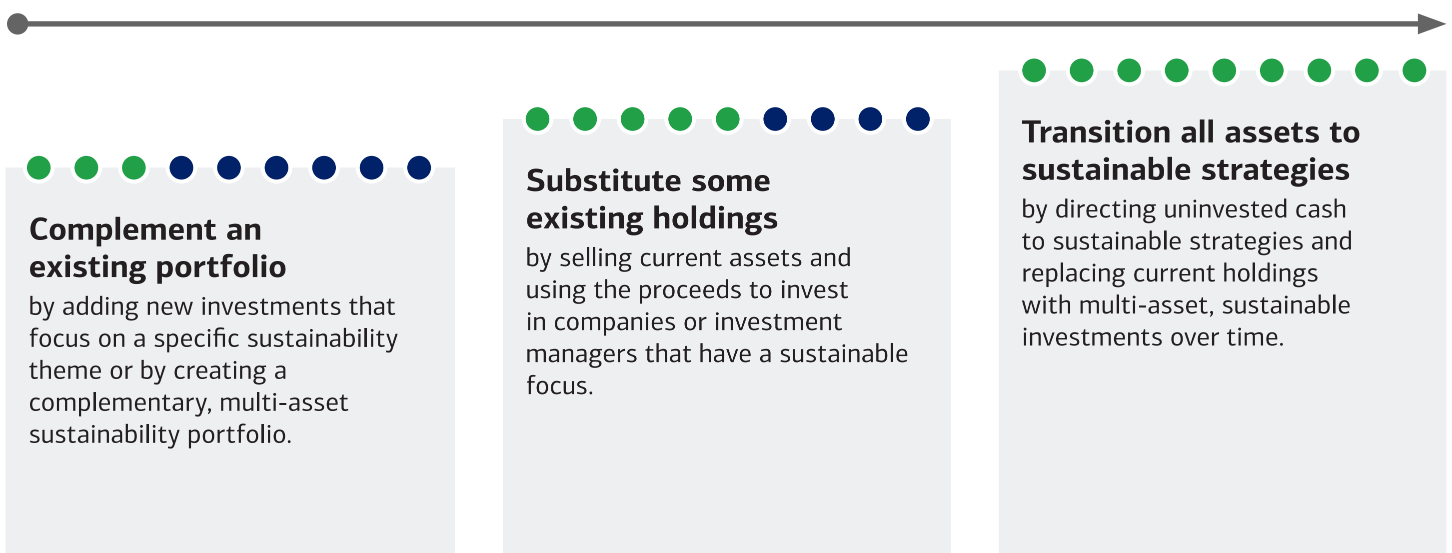
An institution's stated investment goals and sustainability preferences can be used to identify potential solutions that offer a suitable risk/return profile and sustainability characteristics by:

- Evaluating the universe of sustainable investments and identifying those that work with the institution's goals and preferences to inform your implementation options
- If needed, transitioning holdings to sustainable strategies over time to account for potential tax consequences, broader investment goals and market movements
- Monitoring and reporting on sustainability performance alongside financial performance where possible

Institutions also have a choice in how quickly they implement their sustainability approach. Some may elect to slowly adopt sustainable and impact investing as opportunities arise, while others may make targeted carve-outs in their holdings. Still others have been more aggressive in their adoption, making changes uniformly across an entire investment program. An institution's motivations may inform their preferred implementation pathway, which can be affected by the actions of other organizations in their network or a desire to inspire an organization's constituents and donors through changes to their investment portfolio that align with their mission.

Sustainable investing is not an all or nothing proposition

The transition to a sustainable investing approach is not immediate. Depending on a number of factors, including the appetite for sustainable exposure, investment and liquidity needs and even current market conditions, implementation can vary greatly. For many institutions, the transition to sustainable investing is one that occurs over a period of time where sustainable investing practices are adopted over time. This kind of disciplined approach can help institutions achieve their sustainability goals while mitigating the potential negative impacts of rapid, large-scale investment shifts.



* Note: Green circles are illustrative of degree of integration of sustainability that an investor could consider.

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Regardless of how quickly an organization wants to transition its investments to a sustainable approach, there are a few primary approaches that institutions commonly take along their respective journeys into sustainable and impact investing across asset classes, each with benefits and challenges:

Opportunistic: Institutions sometimes start sustainable investing inadvertently. They may find an opportunity to invest in a particular fund which fits their criteria, but they may do so without a lot of strategic considerations. An initial review of an impact area may lead to some interest and a decision to make one or more investments. Investment opportunities may originate in a variety of sources, and the opportunistic approach tends to be an "if the right thing comes our way" orientation.

- *Benefits:* Being opportunistic can prod an institution into action, helping it avoid over-analysis and providing a way to move past stalemates on boards or investment committees.
- *Challenges:* Opportunistic approaches may translate into more concentrated bets on a particular project or investment, may be difficult for an institution to act upon if there is a limited entry opportunity during a capital raise, and possibly could be outside of the typical "universe" of investments such an institution might include in its investment policies.

Carve-out: Some institutions choose to create a "carve-out," essentially a separate test area for sustainable or impact investments. In this case, the typical goal is to segment a defined capital allocation in sustainable or impact investments, either in public or private equity and debt. This carve-out allocation may be invested with the same process, staff and benchmarks as the rest of the portfolio, or the separation may allow for different parameters. For instance, the institution's members may determine that, given their goals, they would prefer to use different staff, approval processes and/or benchmarks. Often, a sustainability carve-out will have a different approval process as well as an additional requirement for reporting.

- *Benefits:* The carve-out approach can help organizations start sustainable investing by giving them experience in addressing any concerns regarding performance or suitability of sustainable or impact investments. It may also be used by board members with points of view that diverge from those of the rest of the board of directors — as it provides an opportunity to push the envelope, so to speak. The separation from the main portfolio permits flexibility and changes implemented successfully in the carve-out portfolio can, over time, be migrated into the main portfolio.
- *Challenges:* Creating a sustainability carve-out may result in the affected investments receiving less focus and fewer resources compared to more traditional investments, relegating it to a kind of secondary status in a portfolio.

Portfolio assessment and activation: Increasingly, we have seen institutions taking a "total portfolio" approach. They typically begin with a portfolio review, seeking to discover conflicts and/or congruence with their mission. Simultaneously, they may explore the universe of investments across asset classes that meet their focus. Using the intersection of existing conflicts and a view of the market opportunities, they may establish a sustainable and impact investing strategy and goals. They may then begin integrating suitable managers and direct investments into their portfolio. This process of gradually "activating" a portfolio can benefit from any improvements in a fast-moving field such as access to better quality data and more sophisticated portfolio construction tools.

- *Benefits:* The approach can bring internal staff and the board of directors together, enabling them to work through key decisions with fewer if any conflicts. As a result, implementation is often smoother, and less time is spent on strategies that don't meet the institution's needs.
- *Challenges:* The process of setting a strategy can be time- and resource-intensive and require investment committee consensus and defined governance processes.

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Catalytic capital: Particularly passionate institutions may choose to move beyond their own portfolios to catalyze all of their assets (including reputation, relationships and grants) to drive capital into sustainable and impact investments that address their mission. These leaders may seek to drive sector impact by catalyzing opportunities and encouraging others to participate. They may attend or convene gatherings of aligned investors, often agreeing to lead and share due diligence. Often they provide grants for research or take first loss positions in these kinds of offerings.

- *Benefits:* For smaller organizations, catalytic approaches provide the potential for outsized impact. Engaging deeply in the field may reveal partnerships for impact and elevate the profile of the organization.
- *Challenges:* The additional commitments of convening and coordinating require resources and strong commitment from across the organization and board. Catalytic impact beyond an organization's own investments rarely happens quickly; it usually takes time to build to successful collaborations and outcomes.

THE ROLE OF THE INVESTMENT POLICY STATEMENT

An institution's investment policy statement (IPS) is vital because it essentially defines the organization's mission and clarifies its investment beliefs, typically spelling out the fundamentals at the heart of the investment process and providing a yardstick to measure success. They may offer perspectives on internal/external, active/passive, macro/micro and quantitative/qualitative factors, as well as market efficiency, asset allocation, risk management, liquidity, time horizon and more. When it comes to adding sustainable and impact investments, the process ideally should be no different.

Whether an institution is starting with a small carve-out allocation or revamping its entire investment program to include impact, it is critical to include well-defined criteria in its IPS.

While the process of establishing an IPS may be time-consuming and potentially contentious, the payoff can be a well-executed sustainable and impact investing strategy where the investment committee, intermediaries and investment managers all have a consistent understanding of the institution's beliefs, goals and implementation guidelines. The IPS should also demonstrate to donors and beneficiaries how the institution is attempting to align its mission/values with its investment program.

In addition, investment beliefs should address the institution's view on ESG factors and sustainability outcomes. Is the incorporation of sustainable and impact investments to promote mission alignment, risk mitigation, return enhancement or all of the above? Clarity on priorities and purpose can allow the IPS to include explicit guidance for managers:

- What types of investments should be sought out, discouraged or avoided?
- Are there specific motivators or industries that should be focused on?
- What kind of assets might need to be added, kept or divested to bring the portfolio in line with your values/mission?
- The measurement of success, in risk, return and impact.

As a note of caution, there is a fine line between being specific about the goals and motivations behind a sustainable and impact investment plan, and being overly prescriptive. Investment managers need to understand the philosophy of the institution, but also should have the flexibility to implement according to their expertise without being second-guessed and micro-managed.

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WRAP-UP

For some institutional board members, incorporating ESG factors into an IPS and investment portfolio may seem like an obvious choice to make, especially if they are well informed or passionate about the strategy. If others are less familiar with sustainable investing, or are concerned about its effectiveness as an investment approach, having access to information and engaging in discussions are essential steps. Even so, we believe that once organizations take the time to carefully define their motivations for including sustainability and impact in their investment process, and work with board members to adapt their institutional IPS, they may more easily move to the next step — implementation. We think that concerns about the breadth and depth of ESG data are less relevant than they once were, as more and more of this information, from corporate sustainability statements to ESG indexes, becomes available almost daily. Additionally, we see ESG integration in policy and practices as a roadmap toward societal and economic benefit. Boards should consider reviewing the scope of data, investment products, and approaches available and, if satisfied, act accordingly to turn to sustainability and impact for a purposeful alignment of their investment portfolio and mission.

For more information on our sustainable and impact investment capabilities, please contact your advisor.

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Index definitions

S&P 500 is a stock market index that tracks the stocks of 500 large-cap U.S. companies. It represents the stock market's performance by reporting the risks and returns of the biggest companies. Investors use it as the benchmark of the overall market, to which all other investments are compared.

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Sustainable and Impact Investing and/or Environmental, Social and Governance (ESG) managers may take into consideration factors beyond traditional financial information to select securities, which could result in relative investment performance deviating from other strategies or broad market benchmarks, depending on whether such sectors or investments are in or out of favor in the market. Further, ESG strategies may rely on certain values based criteria to eliminate exposures found in similar strategies or broad market benchmarks, which could also result in relative investment performance deviating.

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